

HOLLY ENERGY PARTNERS LP
Form 10-Q
May 01, 2012

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the quarterly period ended March 31, 2012

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT
OF 1934

For the transition period from _____ to _____

Commission File Number: 1-32225

HOLLY ENERGY PARTNERS, L.P.
(Exact name of registrant as specified in its charter)

Delaware	20-0833098
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

2828 N. Harwood, Suite 1300
Dallas, Texas 75201
(Address of principal executive offices), (Zip code)
(214) 871-3555
(Registrant's telephone number, including area code)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

Yes No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer" and "smaller reporting company" in Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer Smaller reporting company

Edgar Filing: HOLLY ENERGY PARTNERS LP - Form 10-Q

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act). Yes No

The number of the registrant's outstanding common units at April 27, 2012 was 27,361,124.

Table of Contentsril 19,

HOLLY ENERGY PARTNERS, L.P.
INDEX

<u>FORWARD-LOOKING STATEMENTS</u>	<u>3</u>
<u>PART I. FINANCIAL INFORMATION</u>	<u>4</u>
Item 1. <u>Financial Statements (Unaudited, except December 31, 2011 Balance Sheet)</u>	<u>4</u>
<u>Consolidated Balance Sheets</u>	<u>4</u>
<u>Consolidated Statements of Income</u>	<u>5</u>
<u>Consolidated Statements of Comprehensive Income</u>	<u>6</u>
<u>Consolidated Statements of Cash Flows</u>	<u>7</u>
<u>Consolidated Statement of Partners' Equity</u>	<u>8</u>
<u>Notes to Consolidated Financial Statements</u>	<u>9</u>
Item 2. <u>Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	<u>22</u>
Item 3. <u>Quantitative and Qualitative Disclosures About Market Risk</u>	<u>33</u>
Item 4. <u>Controls and Procedures</u>	<u>33</u>
<u>PART II. OTHER INFORMATION</u>	<u>34</u>
Item 1. <u>Legal Proceedings</u>	<u>34</u>
Item 1A. <u>Risk Factors</u>	<u>34</u>
Item 5. <u>Other Information</u>	<u>34</u>
Item 6. <u>Exhibits</u>	<u>34</u>
<u>SIGNATURES</u>	<u>35</u>
<u>Index to Exhibits</u>	<u>36</u>

Table of Contentsril 19,

FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains certain “forward-looking statements” within the meaning of the federal securities laws. All statements, other than statements of historical fact included in this Form 10-Q, including, but not limited to, those under “Results of Operations” and “Liquidity and Capital Resources” in Item 2 “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Part I are forward-looking statements. Forward looking statements use words such as “anticipate,” “project,” “expect,” “plan,” “goal,” “forecast,” “intend,” “could,” “believe,” similar expressions and statements regarding our plans and objectives for future operations. These statements are based on our beliefs and assumptions and those of our general partner using currently available information and expectations as of the date hereof, are not guarantees of future performance and involve certain risks and uncertainties. Although we and our general partner believe that such expectations reflected in such forward-looking statements are reasonable, neither we nor our general partner can give assurance that our expectations will prove to be correct. Such statements are subject to a variety of risks, uncertainties and assumptions. If one or more of these risks or uncertainties materialize, or if underlying assumptions prove incorrect, our actual results may vary materially from those anticipated, estimated, projected or expected. Certain factors could cause actual results to differ materially from results anticipated in the forward-looking statements. These factors include, but are not limited to:

- risks and uncertainties with respect to the actual quantities of petroleum products and crude oil shipped on our pipelines and/or terminalled, stored or throughput in our terminals;
- the economic viability of HollyFrontier Corporation, Alon USA, Inc. and our other customers;
- the demand for refined petroleum products in markets we serve;
- our ability to successfully purchase and integrate additional operations in the future;
- our ability to complete previously announced or contemplated acquisitions;
- the availability and cost of additional debt and equity financing;
- the possibility of reductions in production or shutdowns at refineries utilizing our pipeline and terminal facilities;
- the effects of current and future government regulations and policies;
- our operational efficiency in carrying out routine operations and capital construction projects;
- the possibility of terrorist attacks and the consequences of any such attacks;
- general economic conditions; and
- other financial, operational and legal risks and uncertainties detailed from time to time in our Securities and Exchange Commission filings.

Cautionary statements identifying important factors that could cause actual results to differ materially from our expectations are set forth in this Form 10-Q, including without limitation, the forward-looking statements that are referred to above. When considering forward-looking statements, you should keep in mind the known material risk factors and other cautionary statements set forth in our Annual Report on Form 10-K for the year ended December 31, 2011 in “Risk Factors” and in this Form 10-Q in “Management’s Discussion and Analysis of Financial Condition and Results of Operations.” All forward-looking statements included in this Form 10-Q and all subsequent written or oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. The forward-looking statements speak only as of the date made and, other than as required by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

Table of Contentsril 19,

PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

Holly Energy Partners, L.P.
Consolidated Balance Sheets

	March 31, 2012 (Unaudited)	December 31, 2011
	(In thousands, except unit data)	
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 12,402	\$ 3,269
Accounts receivable:		
Trade	3,884	3,055
Affiliates	30,900	31,016
	34,784	34,071
Prepaid and other current assets	2,403	2,644
Total current assets	49,589	39,984
Properties and equipment, net	534,244	536,425
Transportation agreements, net	99,806	101,543
Goodwill	256,498	256,498
Investment in SLC Pipeline	25,382	25,302
Other assets	7,319	7,204
Total assets	\$972,838	\$966,956
LIABILITIES AND PARTNERS' EQUITY		
Current liabilities:		
Accounts payable:		
Trade	\$6,368	\$6,107
Affiliates	6,225	5,299
	12,593	11,406
Accrued interest	1,808	8,280
Deferred revenue	3,440	4,032
Accrued property taxes	1,801	2,196
Other current liabilities	1,893	1,777
Current portion of long-term debt	27,239	—
Total current liabilities	48,774	27,691
Long-term debt, net of current portion	597,956	605,888
Other long-term liabilities	4,635	4,000
Partners' equity:		
Common unitholders (27,361,124 units issued and outstanding at March 31, 2012 and December 31, 2011)	473,931	482,509
General partner interest (2% interest)	(146,914)	(146,668)
Accumulated other comprehensive loss	(5,544)	(6,464)

Total partners' equity	321,473	329,377
Total liabilities and partners' equity	\$972,838	\$966,956

See accompanying notes.

- 4 -

Table of Contentsril 19,Holly Energy Partners, L.P.
Consolidated Statements of Income
(Unaudited)

	Three Months Ended March 31,	
	2012	2011
	(In thousands, except per unit data)	
Revenues:		
Affiliates	\$52,793	\$34,107
Third parties	10,722	10,910
	63,515	45,017
Operating costs and expenses:		
Operations	16,988	12,796
Depreciation and amortization	10,264	7,640
General and administrative	2,039	1,363
	29,291	21,799
Operating income	34,224	23,218
Other income (expense):		
Equity in earnings of SLC Pipeline	831	740
Interest expense	(10,405)	) (8,549)
Loss on early extinguishment of debt	(2,596)) —
Other expense	—	) (12)
	(12,170)	) (7,821)
Income before income taxes	22,054	15,397
State income tax expense	(75)	) (228)
Net income	21,979	15,169
Less general partner interest in net income, including incentive distributions	5,507	3,562
Limited partners' interest in net income	\$16,472	\$11,607
Limited partners' per unit interest in earnings—basic and diluted:	\$0.60	\$0.53
Weighted average limited partners' units outstanding	27,361	22,079

See accompanying notes.

Holly Energy Partners, L.P.
 Consolidated Statements of Comprehensive Income
 (Unaudited)

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Net income	\$21,979	\$15,169
Other comprehensive income (loss):		
Change in fair value of cash flow hedge	(354	) 1,283
Amortization of unrealized loss attributable to discontinued cash flow hedge	1,274	—
Other comprehensive income	920	1,283
Comprehensive income	\$22,899	\$16,452

See accompanying notes.

Table of Contentsril 19,Holly Energy Partners, L.P.
Consolidated Statements of Cash Flows
(Unaudited)

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Cash flows from operating activities		
Net income	\$21,979	\$15,169
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	10,264	7,640
Equity in earnings of SLC Pipeline, net of distributions	(81	) (365
Amortization of restricted and performance units	943	670
(Increase) decrease in current assets:		
Accounts receivable—trade	(829	) 442
Accounts receivable—affiliates	(347	) (1,409
Prepaid and other current assets	307	229
Increase (decrease) in current liabilities:		
Accounts payable—trade	(493	) (356
Accounts payable—affiliates	926	443
Accrued interest	(6,472	) (5,976
Deferred revenue	(592	) (1,104
Accrued property taxes	(395	) (252
Other current liabilities	131	(183
Other, net	2,882	274
Net cash provided by operating activities	28,223	15,222
Cash flows from investing activities		
Additions to properties and equipment	(6,327	) (11,475
Cash flows from financing activities		
Borrowings under credit agreement	36,000	30,000
Repayments of credit agreement borrowings	(81,000	) (7,000
Proceeds from issuance of senior notes	294,750	—
Repayments of senior notes	(157,761) —
Repayment of promissory notes	(72,900) —
Distributions to HEP unitholders	(29,716	) (22,205
Purchase of units for incentive grants	(1,283	) (399
Deferred financing costs	(1,123	) (3,044
Other	270	—
Net cash used for financing activities	(12,763	) (2,648
Cash and cash equivalents		
Increase for the period	9,133	1,099
Beginning of period	3,269	403
End of period	\$12,402	\$1,502

See accompanying notes.

Table of Contentsril 19,Holly Energy Partners, L.P.
Consolidated Statement of Partners' Equity
(Unaudited)

	Common Units	General Partner Interest	Accumulated Other Comprehensive Loss	Total
	(In thousands)			
Balance December 31, 2011	\$482,509	\$(146,668)	\$(6,464)	\$329,377
Distributions to unitholders	(24,213)	(5,503)	—	(29,716)
Purchase of units for incentive grants	(2,037)	—	—	(2,037)
Amortization of restricted and performance units	943	—	—	943
Other	—	7	—	7
Net income	16,729	5,250	—	21,979
Other comprehensive income	—	—	920	920
Balance March 31, 2012	\$473,931	\$(146,914)	\$(5,544)	\$321,473

See accompanying notes.

Table of Contentsril 19,

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1: Description of Business and Presentation of Financial Statements

Holly Energy Partners, L.P. (“HEP”) together with its consolidated subsidiaries, is a publicly held master limited partnership, currently 42% owned (including the 2% general partner interest) by HollyFrontier Corporation (“HFC”) and its subsidiaries. In these consolidated financial statements, the words “we,” “our,” “ours” and “us” refer to HEP unless the context otherwise indicates.

We operate in one operating segment—the operation of petroleum product and crude oil pipelines and terminals, tankage and loading rack facilities.

We own and operate petroleum product and crude oil pipelines and terminal, tankage and loading rack facilities that support HFC’s refining and marketing operations in the Mid-Continent, Southwest and Rocky Mountain regions of the United States and Alon USA, Inc.’s (“Alon”) refinery in Big Spring, Texas. Additionally, we own a 25% joint venture interest in a 95-mile intrastate crude oil pipeline system (the “SLC Pipeline”) that serves refineries in the Salt Lake City area.

We generate revenues by charging tariffs for transporting petroleum products and crude oil through our pipelines, by charging fees for terminalling and storing refined products and other hydrocarbons and providing other services at our storage tanks and terminals. We do not take ownership of products that we transport, terminal or store, and therefore, we are not directly exposed to changes in commodity prices.

The consolidated financial statements included herein have been prepared without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission (the “SEC”). The interim financial statements reflect all adjustments, which, in the opinion of management, are necessary for a fair presentation of our results for the interim periods. Such adjustments are considered to be of a normal recurring nature. Although certain notes and other information required by U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted, we believe that the disclosures in these consolidated financial statements are adequate to make the information presented not misleading. These consolidated financial statements should be read in conjunction with our Form 10-K for the year ended December 31, 2011. Results of operations for interim periods are not necessarily indicative of the results of operations that will be realized for the year ending December 31, 2012.

New Accounting Pronouncements

Presentation of Comprehensive Income

Effective January 1, 2012, we adopted the accounting standard update that requires the presentation of net income and other comprehensive income in one continuous statement or in two separate, but consecutive, statements and eliminated the option to present the components of other comprehensive income in the statement of partners' equity.

Intangibles-Goodwill and Other: Testing Goodwill for Impairment

Effective January 1, 2012, we adopted the accounting standard update that allows entities an option to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Under this option, we no longer are required to calculate the fair value of a reporting unit unless we determine, based on that qualitative assessment, that it is more likely than not that the reporting unit's fair value is less than its carrying amount. The adoption of this accounting standard did not have an impact on our financial condition, results of operations and cash flows.

Note 2: Acquisitions

Legacy Frontier Pipeline and Tankage Asset Transaction

On November 9, 2011, we acquired from HFC certain tankage, loading rack and crude receiving assets located at HFC's El Dorado and Cheyenne refineries. We paid non-cash consideration consisting of promissory notes with an aggregate principal amount of \$150.0 million and 3,807,615 of our common units. In connection with the transaction, we entered into 15-year throughput agreements with HFC that result in minimum annual revenue commitments to us of \$46.9 million. We are a consolidated variable interest entity of HFC, and accordingly we accounted for this transaction as a business combination between entities under common control and therefore, we have recorded this transfer at HFC's cost basis.

We recorded properties and equipment of \$88.1 million, goodwill of \$207.4 million and a non-cash capital contribution of \$295.5 million, representing HFC's cost basis in the acquired assets. On November 9, 2011, we recorded a \$150.0 million liability

- 9 -

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

representing the promissory notes issued to HFC at the time of the closing of this transaction and a corresponding decrease to HFC's non-cash contribution.

Assuming this acquisition had occurred on January 1, 2011 and our throughput agreements with HFC were in effect at that time, pro forma revenues, net income and earnings per unit for the three months ended March 31, 2011 are estimated to have been \$56.9 million, \$23.3 million and \$0.74, respectively.

Note 3: Financial Instruments

Our financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, debt and an interest rate swap. The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term maturity of these instruments. Debt consists of outstanding principal under our revolving credit agreement (which approximates fair value as interest rates are reset frequently at current interest rates) and fixed interest rate senior notes.

Fair value measurements are derived using inputs (assumptions that market participants would use in pricing an asset or liability) including assumptions about risk. GAAP categorizes inputs used in fair value measurements into three broad levels as follows:

• (Level 1) Quoted prices in active markets for identical assets or liabilities.

• (Level 2) Observable inputs other than quoted prices included in Level 1, such as quoted prices for similar assets and liabilities in active markets, similar assets and liabilities in markets that are not active or can be corroborated by observable market data.

• (Level 3) Unobservable inputs that are supported by little or no market activity and that are significant to the fair value of the assets or liabilities. This includes valuation techniques that involve significant unobservable inputs.

The carrying amounts and estimated fair values of our senior notes and interest rate swap at March 31, 2012 and December 31, 2011 were as follows:

Financial Instrument	Fair Value Input Level	March 31, 2012		December 31, 2011	
		Carrying Amount	Fair Value	Carrying Amount	Fair Value
(In thousands)					
Senior notes:					
6.25% senior notes	Level 2	\$27,239	\$27,562	\$184,895	\$186,850
6.5% senior notes	Level 2	294,786	305,250	—	—
8.25% senior notes	Level 2	148,170	161,250	148,093	157,500
		470,195	494,062	332,988	344,350
Interest rate swap	Level 2	(873)	(873)	(520)	(520)
		\$469,322	\$493,189	\$332,468	\$343,830

Level 2 Financial Instruments

Our senior notes and interest rate swap are measured and recorded at fair value using Level 2 inputs. The fair value of the senior notes is based on market values provided by a third-party bank, which were derived using market quotes for

similar type instruments. With respect to our interest rate swap, the fair value is based on the net present value of expected future cash flows related to both variable and fixed rate legs of the swap agreement. This measurement is computed using the forward London Interbank Offered Rate ("LIBOR") yield curve, a market based observable input.

See Note 7 for additional information on these instruments.

- 10 -

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

Note 4: Properties and Equipment

The carrying amounts of our properties and equipment are as follows:

	March 31, 2012	December 31, 2011
	(In thousands)	
Pipelines and terminals	\$633,934	\$633,095
Land and right of way	27,149	27,149
Other	16,728	16,507
Construction in progress	19,638	14,419
	697,449	691,170
Less accumulated depreciation	163,205	154,745
	\$534,244	\$536,425

We capitalized \$0.1 million and \$0.2 million in interest related to construction projects during the three months ended March 31, 2012 and 2011, respectively.

Note 5: Transportation Agreements

Our transportation agreements represent a portion of the total purchase price of certain assets acquired from Alon in 2005 and from HFC in 2008 (at which time we were not a consolidated variable interest entity of HFC) that are based on the respective agreement's expected future earnings contribution. The Alon agreement is being amortized over 30 years ending 2035 (the initial 15-year term of the agreement plus an expected 15-year extension period) and the HFC agreement is being amortized over 15 years ending 2023 (the term of the HFC agreement).

The carrying amounts of our transportation agreements are as follows:

	March 31, 2012	December 31, 2011
	(In thousands)	
Alon transportation agreement	\$59,933	\$59,933
HFC transportation agreement	74,231	74,231
	134,164	134,164
Less accumulated amortization	34,358	32,621
	\$99,806	\$101,543

We have additional transportation agreements with HFC that relate to assets contributed to us or acquired from HFC consisting of pipeline, terminal and tankage assets. These transactions occurred while we were a consolidated variable interest entity of HFC, therefore, our basis in these agreements is zero and does not reflect a step-up in basis to fair value.

Note 6: Employees, Retirement and Incentive Plans

Employees who provide direct services to us are employed by Holly Logistic Services, L.L.C., an HFC subsidiary. Their costs, including salaries, bonuses, payroll taxes, benefits and other direct costs, are charged to us monthly in accordance with an omnibus agreement that we have with HFC. These employees participate in the retirement and benefit plans of HFC. Our share of retirement and benefit plan costs was \$1.5 million and \$0.7 million for the three months ended March 31, 2012 and 2011, respectively.

We have an incentive plan (“Long-Term Incentive Plan”) for employees, consultants and non-employee directors who perform services for us. The Long-Term Incentive Plan consists of four components: restricted units, performance units, unit options and unit appreciation rights.

- 11 -

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

As of March 31, 2012, we have two types of equity-based compensation, which are described below. The compensation cost charged against income was \$0.9 million and \$0.7 million for the three months ended March 31, 2012 and 2011, respectively. We currently purchase units in the open market instead of issuing new units for settlement of all unit awards under our Long-Term Incentive Plan. On April 25, 2012 our unitholders approved an amendment and restatement of our Long-Term Incentive Plan, which among other things, increased the units authorized to be granted under our Long-Term Incentive Plan from 350,000 to 1,250,000. Upon such approval, the amendment and restatement of the Long-Term Incentive Plan was effective February 10, 2012, which is the date the amendment and restatement was approved by our board of directors. As a result of such amendment and restatement, 1,250,000 units are authorized to be granted under the Long-Term Incentive Plan, of which 922,221 have not yet been granted, assuming no forfeitures of the unvested units and full achievement of goals for the performance units already granted.

Restricted Units

Under our Long-Term Incentive Plan, we grant restricted units to selected employees and directors who perform services for us, with most awards vesting over a period of one to three years. Although full ownership of the units does not transfer to the recipients until the units vest, the recipients have distribution and voting rights on these units from the date of grant. The fair value of each restricted unit award is measured at the market price as of the date of grant and is amortized over the vesting period.

A summary of restricted unit activity and changes during the three months ended March 31, 2012 is presented below:

Restricted Units	Units	Weighted-Average Grant-Date Fair Value	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (\$000)
Outstanding at January 1, 2012 (nonvested)	29,536	\$50.45		
Granted	38,508	61.21		
Vesting and transfer of full ownership to recipients	(21,240)	52.25		
Outstanding at March 31, 2012 (nonvested)	46,804	\$58.49	1.4 years	\$2,857

The fair value of restricted units that were vested and transferred to recipients during the three months ended March 31, 2012 and 2011 were \$1.1 million and \$1.0 million, respectively. As of March 31, 2012, there was \$1.9 million of total unrecognized compensation expense related to nonvested restricted unit grants which is expected to be recognized over a weighted-average period of 1.4 years.

Performance Units

Under our Long-Term Incentive Plan, we grant performance units to selected executives who perform services for us. Performance units granted are payable based upon the growth in our distributable cash flow per common unit over the performance period, and vest over a period of three years. As of March 31, 2012, estimated share payouts for outstanding nonvested performance unit awards were approximately 110%.

We granted 5,718 performance units to certain officers on March 31, 2012. These units will vest over a three-year performance period ending December 31, 2014 and are payable in HEP common units. The number of units actually

earned will be based on the growth of our distributable cash flow per common unit over the performance period, and can range from 50% to 150% of the number of performance units granted. Although common units are not transferred to the recipients until the performance units vest, the recipients have distribution rights with respect to the common units from the date that the performance units are granted. The fair value of these performance units is based on the grant date closing unit price of \$61.21 and will apply to the number of units ultimately awarded.

A summary of performance unit activity and changes during the three months ended March 31, 2012 is presented below:

- 12 -

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

Performance Units	Payable In Units
Outstanding at January 1, 2012 (nonvested)	42,991
Granted	5,718
Vesting and transfer of common units to recipients	(21,460)
Outstanding at March 31, 2012 (nonvested)	27,249

The fair value of performance units vested and transferred to recipients during the three months ended March 31, 2012 and 2011 was \$0.5 million and \$0.6 million, respectively. Based on the weighted average fair value at March 31, 2012 of \$52.11, there was \$0.9 million of total unrecognized compensation expense related to nonvested performance units, which is expected to be recognized over a weighted-average period of 1.7 years.

During the three months ended March 31, 2012, we paid \$1.3 million for the purchase of our common units in the open market for the issuance and settlement of all unit awards under our Long-Term Incentive Plan.

Note 7: Debt

Credit Agreement

We have a \$375 million senior secured revolving credit facility expiring in February 2016 (the "Credit Agreement") that is available to fund capital expenditures, investments, acquisitions, distribution payments and working capital and for general partnership purposes. Also, it is available to fund letters of credit up to a \$50 million sub-limit and to fund distributions to unitholders up to a \$30 million sub-limit. In February 2012 we amended our previous credit agreements increasing the size of the credit facility from \$275 million to \$375 million.

During the three months ended March 31, 2012, we received advances totaling \$36.0 million and repaid \$81.0 million, resulting in net repayments of \$45.0 million under the Credit Agreement and an outstanding balance of \$155.0 million at March 31, 2012.

Our obligations under the Credit Agreement are collateralized by substantially all of our assets. Indebtedness under the Credit Agreement is recourse to HEP Logistics Holdings, L.P., ("HEP Logistics"), our general partner, and guaranteed by our material wholly-owned subsidiaries. Any recourse to HEP Logistics would be limited to the extent of its assets, which other than its investment in us, are not significant. We may prepay all loans at any time without penalty, except for payment of certain breakage and related costs.

The Credit Agreement imposes certain requirements on us which we are subject to and currently in compliance with, including: a prohibition against distribution to unitholders if, before or after the distribution, a potential default or an event of default as defined in the agreement would occur; limitations on our ability to incur debt, make loans, acquire other companies, change the nature of our business, enter a merger or consolidation, or sell assets; and covenants that require maintenance of a specified EBITDA to interest expense ratio, total debt to EBITDA ratio and senior debt to EBITDA ratio. If an event of default exists under the Credit Agreement, the lenders will be able to accelerate the maturity of the debt and exercise other rights and remedies.

Senior Notes

In March 2012, we issued \$300.0 million in aggregate principal amount outstanding of 6.5% senior notes maturing March 1, 2020 (the "6.5% Senior Notes"). The \$294.8 million in net proceeds from the issuance were used to fund \$157.8 million aggregate principal amount of 6.25% Senior Notes tendered pursuant to a cash tender offer and consent solicitation announced in February 2012, to repay \$72.9 million in Promissory Notes due to HFC as discussed below, related fees, expenses and accrued interest in connection with these transactions and to repay borrowings under the Credit Agreement.

In April 2012, we called for redemption \$27.2 million aggregate principal amount of 6.25% senior notes that remained outstanding following the cash tender offer and consent solicitation.

In March 2010, we issued \$150.0 million in aggregate principal amount outstanding of 8.25% senior notes (the "8.25% Senior Notes") maturing March 15, 2018. A portion of the \$147.5 million in net proceeds from the issuance was used to fund our \$93.0 million purchase of the Tulsa and Lovington storage assets from HFC on March 31, 2010. Additionally, we used a portion to repay \$42.0 million in outstanding Credit Agreement borrowings, with the remaining proceeds available for general partnership

- 13 -

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

purposes, including working capital and capital expenditures.

The 6.5% Senior Notes and 8.25% Senior Notes (collectively, the “Senior Notes”) are unsecured and impose certain restrictive covenants, which we are subject to and currently in compliance with, including limitations on our ability to incur additional indebtedness, make investments, sell assets, incur certain liens, pay distributions, enter into transactions with affiliates, and enter into mergers. At any time when the Senior Notes are rated investment grade by both Moody’s and Standard & Poor’s and no default or event of default exists, we will not be subject to many of the foregoing covenants. Additionally, we have certain redemption rights under the Senior Notes.

Indebtedness under the Senior Notes is recourse to HEP Logistics, our general partner, and guaranteed by our wholly-owned subsidiaries. However, any recourse to HEP Logistics would be limited to the extent of its assets, which other than its investment in us, are not significant.

Promissory Notes

In November 2011, we issued senior unsecured promissory notes to HFC (the “Promissory Notes”) having an aggregate principal amount of \$150 million to finance a portion of our November 9, 2011 acquisition of certain tankage, loading rack and crude receiving assets located at HFC’s El Dorado and Cheyenne refineries (see Note 2). In December 2011, we repaid \$77.1 million of outstanding principal using proceeds received in our December 2011 common unit offering and existing cash. We repaid the remaining \$72.9 million balance in March 2012.

Long-term Debt

The carrying amounts of our long-term debt are as follows:

	March 31, 2012	December 31, 2011
	(In thousands)	
Credit Agreement	\$155,000	\$200,000
6.5% Senior Notes		
Principal	300,000	—
Unamortized discount	(5,214)	—
	294,786	—
6.25% Senior Notes		
Principal	27,254	185,000
Unamortized net discount	(15)	(105)
	27,239	184,895
8.25% Senior Notes		
Principal	150,000	150,000
Unamortized discount	(1,830)	(1,907)
	148,170	148,093
Promissory Notes	—	72,900
Total debt	625,195	605,888
Less current portion of long-term debt	27,239	—
Total long-term debt	\$597,956	\$605,888

Interest Rate Risk Management

We use interest rate swaps (derivative instruments) to manage our exposure to interest rate risk.

As of March 31, 2012, we have an interest rate swap that hedges our exposure to the cash flow risk caused by the effects of LIBOR changes on a \$155.0 million Credit Agreement advance. This interest rate swap effectively converts \$155.0 million of our LIBOR based debt to fixed rate debt having an interest rate of 0.99% plus an applicable margin, currently 2.25%, which equaled an effective interest rate of 3.24% as of March 31, 2012. This swap contract matures in February 2016.

- 14 -

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

We have designated this interest rate swap as a cash flow hedge. Based on our assessment of effectiveness using the change in variable cash flows method, we have determined that this interest rate swap is effective in offsetting the variability in interest payments on \$155.0 million of our variable rate debt resulting from changes in LIBOR. Under hedge accounting, we adjust our cash flow hedge on a quarterly basis to its fair value with the offsetting fair value adjustment to accumulated other comprehensive loss. Also on a quarterly basis, we measure hedge effectiveness by comparing the present value of the cumulative change in the expected future interest to be paid or received on the variable leg of our swap against the expected future interest payments on \$155.0 million of our variable rate debt. Any ineffectiveness is reclassified from accumulated other comprehensive loss to interest expense. As of March 31, 2012, we had no ineffectiveness on our cash flow hedge.

At March 31, 2012, we have an accumulated other comprehensive loss of \$5.5 million that relates to our current and previous cash flow hedging instruments. Of this amount, \$4.7 million represents an unrecognized loss that is attributable to a cash flow hedge terminated in December 2011 and represents the application of hedge accounting prior to termination. This amount will be amortized as a charge to interest expense through February 2013, the remaining term of the terminated swap contract. The remaining \$0.8 million amount will be effectively transferred from accumulated other comprehensive loss into interest expense as interest is paid on the underlying swap agreement over the next twelve-month period, assuming interest rates remain unchanged.

Additional information on our interest rate swap is as follows:

Derivative Instrument	Balance Sheet Location (In thousands)	Fair Value	Location of Offsetting Balance	Offsetting Amount
March 31, 2012				
Interest rate swap designated as cash flow hedging instrument:				
Variable-to-fixed interest rate swap contract (\$155 million of LIBOR based debt interest)	Other long-term liabilities	\$873	Accumulated other comprehensive loss	\$873
December 31, 2011				
Interest rate swap designated as cash flow hedging instrument:				
Variable-to-fixed interest rate swap contract (\$155 million of LIBOR based debt interest)	Other long-term liabilities	\$520	Accumulated other comprehensive loss	\$520

Interest Expense and Other Debt Information

Interest expense consists of the following components:

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
Interest on outstanding debt:		
Credit Agreement, net of interest on interest rate swap	\$1,575	\$2,365
6.5% Senior Notes	1,083	—
6.25% Senior Notes	2,370	2,891
8.25% Senior Notes	3,094	3,094
Promissory Notes	543	—
Amortization of discount and deferred debt issuance costs	1,645	290

Edgar Filing: HOLLY ENERGY PARTNERS LP - Form 10-Q

Commitment fees	167	113
Total interest incurred	10,477	8,753
Less capitalized interest	72	204
Net interest expense	\$10,405	\$8,549
Cash paid for interest	\$15,292	\$14,439

We recognized a charge of \$2.6 million upon the early extinguishment of certain long-term debt for the three months ended March 31, 2012. This charge represents the premium paid to our 6.25% senior note holders upon their tender of an aggregate principal amount of \$157.8 million and related net discount.

- 15 -

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

Note 8: Significant Customers

All revenues are domestic revenues, of which 96% are currently generated from our two largest customers: HFC and Alon. The vast majority of our revenues are derived from activities conducted in the southwest United States.

The following table presents the percentage of total revenues generated by each of these customers:

	Three Months Ended March 31,		
	2012	2011	
HFC	83	% 76	%
Alon	13	% 20	%

Note 9: Related Party Transactions

We serve HFC's refineries under long-term pipeline and terminal, tankage and throughput agreements expiring from 2019 to 2026. Under these agreements, HFC agreed to transport, store and throughput volumes of refined product and crude oil on our pipelines and terminal, tankage and loading rack facilities that result in minimum annual payments to us. These minimum annual payments or revenues are subject to annual tariff rate adjustments on July 1, based on the Producer Price Index ("PPI") or Federal Energy Regulatory Commission ("FERC") index. As of March 31, 2012, these agreements with HFC will result in minimum annualized payments to us of \$191.8 million.

If HFC fails to meet its minimum volume commitments under the agreements in any quarter, it will be required to pay us in cash the amount of any shortfall by the last day of the month following the end of the quarter. Under certain of these agreements, a shortfall payment may be applied as a credit in the following four quarters after minimum obligations are met.

Under certain provisions of an omnibus agreement we have with HFC (the "Omnibus Agreement") we pay HFC an annual administrative fee for the provision by HFC or its affiliates of various general and administrative services to us, currently \$2.3 million. This fee does not include the salaries of pipeline and terminal personnel or the cost of their employee benefits, which are charged to us separately by HFC. Also, we reimburse HFC and its affiliates for direct expenses they incur on our behalf.

Related party transactions with HFC are as follows:

Revenues received from HFC were \$52.8 million and \$34.1 million for the three months ended March 31, 2012 and 2011, respectively.

HFC charged general and administrative services under the Omnibus Agreement of \$0.6 million for the three months ended March 31, 2012 and 2011.

We reimbursed HFC for costs of employees supporting our operations of \$7.6 million and \$5.0 million for the three months ended March 31, 2012 and 2011, respectively.

We distributed \$15.3 million and \$9.7 million for the three months ended March 31, 2012 and 2011, respectively, to HFC as regular distributions on its common units and general partner interest, including general partner incentive distributions.

Accounts receivable from HFC were \$30.9 million and \$31.0 million at March 31, 2012 and December 31, 2011, respectively.

Accounts payable to HFC were \$6.2 million and \$5.3 million at March 31, 2012 and December 31, 2011, respectively.

Revenues for the three months ended March 31, 2012 include \$1.7 million of shortfall payments billed in 2011, as HFC did not exceed its minimum volume commitment in any of the subsequent four quarters. Deferred revenue in the consolidated balance sheets at March 31, 2012 and December 31, 2011, includes \$3.4 million and \$4.0 million, respectively, relating to certain shortfall billings. It is possible that HFC may not exceed its minimum obligations to receive credit for any of the \$3.4 million deferred at March 31, 2012.

We acquired tankage and terminal assets from HFC in 2011. See Note 2 for a description of this transaction.

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

Note 10: Partners' Equity

HFC currently holds 11,097,615 of our common units and the 2% general partner interest, which together constitute a 42% ownership interest in us.

Allocations of Net Income

Net income attributable to HEP is allocated between limited partners and the general partner interest in accordance with the provisions of the partnership agreement. HEP net income allocated to the general partner includes incentive distributions that are declared subsequent to quarter end. After the amount of incentive distributions is allocated to the general partner, the remaining net income attributable to HEP is allocated to the partners based on their weighted-average ownership percentage during the period.

The following table presents the allocation of the general partner interest in net income for the periods presented below:

	Three Months Ended March 31,	
	2012	2011
	(In thousands)	
General partner interest in net income	\$ 336	\$ 237
General partner incentive distribution	5,171	3,325
Total general partner interest in net income	\$5,507	\$3,562

Cash Distributions

Our general partner, HEP Logistics, is entitled to incentive distributions if the amount we distribute with respect to any quarter exceeds specified target levels.

On April 25, 2012, we announced our cash distribution for the first quarter of 2012 of \$0.895 per unit. The distribution is payable on all common and general partner units and will be paid May 15, 2012 to all unitholders of record on May 8, 2012.

The following table presents the allocation of our regular quarterly cash distributions to the general and limited partners for the periods in which they apply. Our distributions are declared subsequent to quarter end; therefore, the amounts presented do not reflect distributions paid during the periods presented below.

	Three Months Ended March 31,	
	2012	2011
	(In thousands, except per unit data)	
General partner interest	\$606	\$453
General partner incentive distribution	5,171	3,325
Total general partner distribution	5,777	3,778
Limited partner distribution	24,488	18,877
Total regular quarterly cash distribution	\$30,265	\$22,655
Cash distribution per unit applicable to limited partners	\$0.895	\$0.855

As a master limited partnership, we distribute our available cash, which historically has exceeded our net income because depreciation and amortization expense represents a non-cash charge against income. The result is a decline in our partners' equity since our regular quarterly distributions have exceeded our quarterly net income. Additionally, if the assets contributed and acquired from HFC had occurred while we were not a consolidated variable interest entity of HFC, our acquisition cost in excess of HFC's historical basis in the transferred assets of \$295.6 million would have been recorded in our financial statements as increases to our properties and equipment and intangible assets instead of decreases to our partners' equity.

Note 11: Supplemental Guarantor/Non-Guarantor Financial Information

Obligations of HEP ("Parent") under the Senior Notes have been jointly and severally guaranteed by each of its direct and indirect wholly-owned subsidiaries ("Guarantor Subsidiaries"). These guarantees are full and unconditional.

- 17 -

HOLLY ENERGY PARTNERS, L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited) Continued

The following financial information presents condensed consolidating balance sheets, statements of income, and statements of cash flows of the Parent and the Guarantor Subsidiaries. The information has been presented as if the Parent accounted for its ownership in the Guarantor Subsidiaries using the equity method of accounting.

Additionally, the following financial information does not include condensed consolidating statements of comprehensive income since all other comprehensive income activity relates to the Parent and not to the Guarantor Subsidiaries.

Condensed Consolidating Balance Sheet

March 31, 2012	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
	(In thousands)			
ASSETS				
Current assets:				
Cash and cash equivalents	\$2	\$12,400	\$—	\$12,402
Accounts receivable	—	34,784	—	34,784
Intercompany accounts receivable (payable)	107,624	(107,624)) —	—
Prepaid and other current assets	246	2,157	—	2,403
Total current assets	107,872	(58,283)	) —	49,589
Properties and equipment, net	—	534,244	—	534,244
Investment in subsidiaries	684,863	—	(684,863)) —
Transportation agreements, net	—	99,806	—	99,806
Goodwill	—	256,498	—	256,498
Investment in SLC Pipeline	—	25,382	—	25,382
Other assets	1,323	5,996	—	7,319
Total assets	\$794,058	\$863,643	\$(684,863)	) \$972,838
LIABILITIES AND PARTNERS' EQUITY				
Current liabilities:				
Accounts payable	\$4	\$12,589	\$—	\$12,593
Accrued interest	1,775	33	—	1,808
Deferred revenue	—	3,440	—	3,440
Accrued property taxes	—	1,801	—	1,801
Other current liabilities	611	1,282	—	1,893
Current portion of long-term debt	27,239	—	—	27,239
Total current liabilities	29,629	19,145	—	48,774
Long-term debt, net of current portion	442,956	155,000	—	597,956
Other long-term liabilities	—	4,635	—	4,635
Partners' equity	321,473	684,863	(684,863)	) 321,473
Total liabilities and partners' equity	\$794,058	\$863,643	\$(684,863)	) \$972,838

HOLLY ENERGY PARTNERS, L.P.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(Unaudited) Continued

Condensed Consolidating Balance Sheet

December 31, 2011	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
	(In thousands)			
ASSETS				
Current assets:				
Cash and cash equivalents	\$2	\$3,267	\$—	\$3,269
Accounts receivable	—	34,071	—	34,071
Intercompany accounts receivable (payable)	17,745	(17,745) —	—
Prepaid and other current assets	266	2,378	—	2,644
Total current assets	18,013	21,971	—	39,984
Properties and equipment, net	—	536,425	—	536,425
Investment in subsidiaries	651,217	—	(651,217) —
Transportation agreements, net	—	101,543	—	101,543
Goodwill	—	256,498	—	256,498
Investment in SLC Pipeline	—	25,302	—	25,302
Other assets	1,322	5,882	—	7,204
Total assets	\$670,552	\$947,621	\$(651,217	) \$966,956
LIABILITIES AND PARTNERS' EQUITY				
Current liabilities:				
Accounts payable	\$—	\$11,406	\$—	\$11,406
Accrued interest	7,498	782	—	8,280
Deferred revenue	—	4,032	—	4,032
Accrued property taxes	—	2,196	—	2,196
Other current liabilities	689	1,088	—	1,777
Total current liabilities	8,187	19,504	—	27,691
Long-term debt	332,988	272,900	—	605,888
Other long-term liabilities	—	4,000	—	4,000
Partners' equity	329,377	651,217	(651,217	) 329,377
Total liabilities and partners' equity	\$670,552	\$947,621	\$(651,217	) \$966,956

HOLLY ENERGY PARTNERS, L.P.
 NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
 (Unaudited) Continued

Condensed Consolidating Statement of Income

Three Months Ended March 31, 2012

	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
	(In thousands)			
Revenues:				
Affiliates	\$—	\$52,793	\$—	\$52,793
Third parties	—	10,722	—	10,722
	—	63,515	—	63,515
Operating costs and expenses:				