HOLLY ENERGY PARTNERS LP
Form 10-Q
April 29, 2011

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

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

For the quarterly period ended March 31, 2011

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES 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 (State or other jurisdiction of incorporation or organization)	20-0833098 (I.R.S. Employer Identification No.)

100 Crescent Court, Suite 1600
Dallas, Texas 75201-6915
(Address of principal executive offices)
(214) 871-3555
(Registrant s telephone number, including area code)
None
(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 þ No o

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 o No o

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 o Accelerated filer þ Non-accelerated filer o Smaller reporting company o

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

The number of the registrant s outstanding common units at April 22, 2011 was 22,078,509.

HOLLY ENERGY PARTNERS, L.P.
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PART I. FINANCIAL INFORMATION

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, b 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 in our terminals;
- the economic viability of Holly 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 risk factors and other cautionary statements set forth in our Annual Report on Form 10-K for the year ended December 31, 2010 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.

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Item 1. Financial Statements

Holly Energy Partners, L.P.
Consolidated Balance Sheets

	March 31, 2011 (Unaudited)	December 31, 2010
	(In thousands, except unit data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 1,502	$ 403
Accounts receivable:		
Trade	3,102	3,544
Affiliates	20,373	18,964
	23,475	22,508
Prepaid and other current assets	546	775
Total current assets	25,523	23,686
Properties and equipment, net	440,523	434,950
Transportation agreements, net	106,753	108,489
Goodwill	49,109	49,109
Investment in SLC Pipeline	25,802	25,437
Other assets	4,440	1,602
Total assets	$ 652,150	$ 643,273
LIABILITIES AND PARTNERS EQUITY		
Current liabilities:		
Accounts payable:		
Trade	$ 5,991	$ 6,347
Affiliates	4,334	3,891
	10,325	10,238
Accrued interest	1,541	7,517
Deferred revenue	9,333	10,437
Accrued property taxes	1,738	1,990
Other current liabilities	1,079	1,262
Total current liabilities	24,016	31,444
Long-term debt	514,733	491,648
Other long-term liabilities	9,511	10,809

Partners equity:				
Common unitholders (22,078,509 units issued and outstanding at March 31, 2011 and December 31, 2010)		265,087		271,649
General partner interest (2% interest)		(152,454)		(152,251)
Accumulated other comprehensive loss		(8,743)		(10,026)
Total partners equity		103,890		109,372
Total liabilities and partners equity	$	652,150	$	643,273

See accompanying notes.

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

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
	(In thousands, except per unit data)	
Revenues:		
Affiliates	$ 34,107	$ 33,597
Third parties	10,910	7,099
	45,017	40,696
Operating costs and expenses:		
Operations	12,796	13,060
Depreciation and amortization	7,640	7,210
General and administrative	1,363	2,563
	21,799	22,833
Operating income	23,218	17,863
Other income (expense):		
Equity in earnings of SLC Pipeline	740	481
Interest income		3
Interest expense	(8,549)	(7,544)
Other expense	(12)	(7)
	(7,821)	(7,067)
Income before income taxes	15,397	10,796
State income tax	(228)	(94)
Net income	15,169	10,702
Less general partner interest in net income, including incentive distributions	3,562	2,646
Limited partners interest in net income	$ 11,607	$ 8,056
Limited partners per unit interest in earnings basic and diluted:	$ 0.53	$ 0.36

Weighted average limited partners units outstanding	22,079	22,079

See accompanying notes.

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

	Three Months Ended March 31, 2011	Three Months Ended March 31, 2010
	(In thousands)	
Cash flows from operating activities		
Net income	$ 15,169	$ 10,702
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	7,640	7,210
Equity in earnings of SLC Pipeline, net of distributions	(365)	(481)
Change in fair value interest rate swaps		1,464
Amortization of restricted and performance units	670	966
(Increase) decrease in current assets:		
Accounts receivable trade	442	392
Accounts receivable affiliates	(1,409)	(2,081)
Prepaid and other current assets	229	225
Current assets of discontinued operations		2,195
Increase (decrease) in current liabilities:		
Accounts payable trade	(356)	(499)
Accounts payable affiliates	443	504
Accrued interest	(5,976)	(1,157)
Deferred revenue	(1,104)	1,108
Accrued property taxes	(252)	(214)
Other current liabilities	(183)	(109)
Other, net	274	(1,502)
Net cash provided by operating activities	15,222	18,723
Cash flows from investing activities		
Additions to properties and equipment	(11,475)	(1,911)
Acquisition of assets from Holly Corporation		(37,234)
Net cash used for investing activities	(11,475)	(39,145)
Cash flows from financing activities		
Borrowings under credit agreement	30,000	33,000
Repayments of credit agreement borrowings	(7,000)	(68,000)
Proceeds from issuance of senior notes		147,540
Distributions to HEP unitholders	(22,205)	(20,506)
Purchase price in excess of transferred basis in assets acquired from Holly Corporation		(55,766)
Purchase of units for restricted grants	(399)	(1,745)
Deferred financing costs	(3,044)	
Net cash provided by (used for) financing activities	(2,648)	34,523

Cash and cash equivalents		
Increase for the period	1,099	14,101
Beginning of period	403	2,508
End of period	$ 1,502	$ 16,609

See accompanying notes.

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Holly Energy Partners, L.P.
Consolidated Statement of Partners Equity
(Unaudited)

	Common Units	General Partner Interest	Accumulated Other Comprehensive Loss	Total
Balance December 31, 2010	$ 271,649	$ (152,251)	$ (10,026)	$ 109,372
Distributions to HEP unitholders	(18,648)	(3,557)		(22,205)
Purchase of units for restricted grants	(399)			(399)
Amortization of restricted and performance units	670			670
Comprehensive income:				
Net income	11,815	3,354		15,169
Other comprehensive income			1,283	1,283
Comprehensive income	11,815	3,354	1,283	16,452
Balance March 31, 2011	$ 265,087	$ (152,454)	$ (8,743)	$ 103,890

See accompanying notes.

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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 34% owned (including the 2% general partner interest) by Holly Corporation (Holly) and its subsidiaries. We commenced operations on July 13, 2004 upon the completion of our initial public offering. In these consolidated financial statements, the words we, our, ours and us refer to HEP unless the context otherwise indicate

We operate in one business 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 Holly s refining and marketing operations in west Texas, New Mexico, Utah, Oklahoma, Idaho and Arizona. We also own and operate refined product pipelines and terminals, located primarily in Texas, that service 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 refined products and other hydrocarbons and storing 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, 2010. 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, 2011.

On the Consolidated Balance Sheet for the year ended December 31, 2010, we have reclassified $10.3 in partner s equity from the general partner interest to our common unitholders and have revised the corresponding equity balances at December 31, 2010 in the Consolidated Statement of Partners Equity. This amount represents general partner incentive distributions paid in 2010 that were incorrectly classified as common unit distributions.

Note 2: Acquisitions

2010 Acquisitions

Tulsa East / Lovington Storage Asset Transaction

On March 31, 2010, we acquired from Holly certain storage assets for $88.6 million consisting of hydrocarbon storage tanks having approximately 2 million barrels of storage capacity, a rail loading rack and a truck unloading rack located at Holly s Tulsa refinery east facility.

Also, as part of this same transaction, we acquired Holly s asphalt loading rack facility located at its Navajo refinery facility in Lovington, New Mexico for $4.4 million.

We are a consolidated variable interest entity of Holly. In accounting for these acquisitions from Holly, we recorded total property and equipment at Holly s cost basis of $37.2 million and the purchase price in excess of Holly s basis in the assets of $55.8 million as a decrease to our partners equity.

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.

Our debt consists of borrowings outstanding under our $275 million revolving credit agreement (the Credit Agreement), our 6.25% senior notes due 2015 (the 6.25% Senior Notes) and our 8.25% senior notes due 2018 (the 8.25% Senior Notes). The $182 million carrying amount of borrowings outstanding under the Credit Agreement approximates fair value as interest rates are reset frequently using current rates. The estimated fair values of our 6.25% Senior Notes and 8.25% Senior Notes were $185 million and $160.5 million, respectively, at March 31, 2011. These fair value estimates are based on market quotes provided from a third-party bank. See Note 7 for additional information on these instruments.

Fair Value Measurements

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.

We have an interest rate swap that is measured at fair value on a recurring basis using Level 2 inputs that as of March 31, 2011 represented a liability having a fair value of $8.7 million. With respect to this instrument, fair value is based on the net present value of expected future cash flows related to both variable and fixed rate legs of our interest rate swap agreement. Our 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 our interest rate swap.

Note 4: Properties and Equipment

	March 31, 2011	December 31, 2010
	(In thousands)	
Pipelines and terminals	$ 509,064	$ 507,260
Land and right of way	25,271	25,264
Other	15,018	14,591
Construction in progress	25,799	16,601
	575,152	563,716
Less accumulated depreciation	134,629	128,766
	$ 440,523	$ 434,950

We capitalized $0.2 million and $0.1 million in interest related to major construction projects during the three months ended March 31, 2011 and 2010, respectively.

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Note 5: Transportation Agreements

Our transportation agreements consist of the following:

The Alon pipelines and terminals agreement (the Alon PTA) represents a portion of the total purchase price of the Alon assets acquired in 2005 that was allocated based on an estimated fair value derived under an income approach. This asset is being amortized over 30 years ending 2035, the 15-year initial term of the Alon PTA plus the expected 15-year extension period.

The Holly crude pipelines and tankage agreement (the Holly CPTA) represents a portion of the total purchase price of certain crude pipelines and tankage assets acquired from Holly in 2008 (at which time we were not a consolidated variable interest entity of Holly) that was allocated using a fair value based on the agreement s expected contribution to our future earnings under an income approach. This asset is being amortized over 15 years ending 2023, the 15-year term of the Holly CPTA.

The carrying amounts of our transportation agreements are as follows:

	March 31, 2011	December 31, 2010
	(In thousands)	
Alon transportation agreement	$ 59,933	$ 59,933
Holly crude pipelines and tankage agreement	74,231	74,231
	134,164	134,164
Less accumulated amortization	27,411	25,675
	$ 106,753	$ 108,489

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

In addition, we have an agreement to provide transportation and storage services to Holly via our Tulsa logistics and storage assets acquired from Sinclair. Since this agreement is with Holly and not between Sinclair and us, there is no purchase price allocation attributable to this agreement.

Note 6: Employees, Retirement and Incentive Plans

Employees who provide direct services to us are employed by Holly Logistic Services, L.L.C., a Holly 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 Holly. These employees participate in the retirement and benefit plans of Holly. Our share of retirement and benefit plan costs was $0.7 million for the three months ended March 31, 2011 and 2010.

We have adopted 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.

As of March 31, 2011, we have two types of equity-based compensation, which are described below. The compensation cost charged against income for these plans was $0.7 million and $1 million for the three months ended March 31, 2011 and 2010, respectively. We currently purchase units in the open market instead of issuing new units for settlement of restricted unit grants. At March 31, 2011, 350,000 units were authorized to be granted under the equity-based compensation plans, of which 63,027 had not yet been granted.

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Restricted Units

Under our Long-Term Incentive Plan, we grant restricted units to selected employees and directors who perform services for us, with vesting generally over a period of one to five 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, 2011 is presented below:

Restricted Units	**Grants**	**Weighted-Average Grant-Date Fair Value**	**Weighted-Average Remaining Contractual Term**	**Aggregate Intrinsic Value ($000)**
Outstanding at January 1, 2011 (nonvested)	47,295	$ 37.47		
Granted	20,924	59.65		
Vesting and transfer of full ownership to recipients	(24,055)	41.48		
Forfeited	(7,802)	43.71		
Outstanding at March 31, 2011 (nonvested)	36,362	$ 46.24	1.2 years	$ 2,109

The fair value of restricted units that were vested and transferred to recipients during the three months ended March 31, 2011 and 2010 were $1 million and $1.3 million, respectively. As of March 31, 2011, there was $1.1 million of total unrecognized compensation costs related to nonvested restricted unit grants. That cost is expected to be recognized over a weighted-average period of 1.2 years.

During the three months ended March 31, 2011, we paid $0.4 million for the purchase of our common units in the open market for the recipients of our restricted unit grants.

Performance Units

Under our Long-Term Incentive Plan, we grant performance units to selected executives who perform services for us. Performance units granted in 2011 and 2010 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. Performance units granted in 2009 are payable based upon the growth in distributions on our common units during the requisite period, and vest over a period of three years. As of March 31, 2011, estimated share payouts for outstanding nonvested performance unit awards ranged from 110% to 120%.

We granted 12,113 performance units to certain officers in March 2011. These units will vest over a three-year performance period ending December 31, 2013 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. The fair value of these performance units is based on the grant date closing unit price of $59.65 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, 2011 is presented below:

Performance Units	**Payable**