

HOLLY ENERGY PARTNERS LP

Form 10-Q

August 06, 2007

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**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 June 30, 2007**

**OR**

**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

20-0833098

(State or other jurisdiction of  
incorporation or organization)

(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  No

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

Large accelerated filer

Accelerated filer

Non-accelerated filer

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 July 20, 2007 was 8,170,000.

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. These statements are based on management's beliefs and assumptions 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 believe that the expectations reflected in these forward-looking statements are reasonable, we cannot assure you that our expectations will prove correct. Therefore, actual outcomes and results could differ materially from what is expressed, implied or forecast in these statements. Any differences could be caused by a number of factors, including, but not limited to:

Risks and uncertainties with respect to the actual quantities of petroleum products 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 pending or contemplated acquisitions;

The availability and cost of our 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, operations 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, in conjunction with the forward-looking statements included in this Form 10-Q 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, 2006 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 Contents****Item 1. Financial Statements****Holly Energy Partners, L.P.  
Consolidated Balance Sheets**

|   | <b>June 30,<br/>2007<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2006</b> |
|---|--|----------------------------------|
|   | (In thousands, except unit data)         |                                  |
| <b>ASSETS</b>   |  |                                  |
| <b>Current assets:</b>  |  |                                  |
| Cash and cash equivalents   | \$ 11,563                                | \$ 11,555                        |
| Accounts receivable:  |  |                                  |
| Trade   | 4,575                                    | 7,339                            |
| Affiliates  | 3,891                                    | 3,518                            |
|   | 8,466                                    | 10,857                           |
| Prepaid and other current assets  | 938                                      | 1,212                            |
| Total current assets  | 20,967                                   | 23,624                           |
| Properties and equipment, net   | 156,671                                  | 160,484                          |
| Transportation agreements, net  | 55,272                                   | 56,821                           |
| Other assets  | 2,279                                    | 2,644                            |
| <b>Total assets</b>   | <b>\$ 235,189</b>                        | <b>\$ 243,573</b>                |
| <b>LIABILITIES AND PARTNERS EQUITY</b>                                  |  |                                  |
| <b>Current liabilities:</b>   |  |                                  |
| Accounts payable  | \$ 1,872                                 | \$ 3,781                         |
| Accrued interest  | 2,932                                    | 2,941                            |
| Deferred revenue  | 4,495                                    | 5,486                            |
| Accrued property taxes  | 614                                      | 868                              |
| Other current liabilities   | 721                                      | 1,098                            |
| Total current liabilities   | 10,634                                   | 14,174                           |
| Commitments and contingencies   |  |                                  |
| Long-term debt  | 181,443                                  | 180,660                          |
| Other long-term liabilities   | 970                                      | 1,550                            |
| Minority interest   | 11,003                                   | 10,963                           |
| <b>Partners equity (deficit):</b>                                       |  |                                  |
| Common unitholders (8,170,000 units issued and outstanding)             | 174,248                                  | 176,844                          |
| Subordinated unitholders (7,000,000 units issued and outstanding)       | (72,131)                                 | (70,022)                         |
| Class B subordinated unitholders (937,500 units issued and outstanding) | 23,186                                   | 23,469                           |
| General partner interest (2% interest)                                  | (94,164)                                 | (94,065)                         |

|  |            |            |
|--|------------|------------|
| <b>Total partners equity</b>                 | 31,139     | 36,226     |
| <b>Total liabilities and partners equity</b> | \$ 235,189 | \$ 243,573 |

See accompanying notes.

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

|  | <b>Three Months Ended</b>            |             | <b>Six Months Ended</b> |             |
|--|--------------------------------------|-------------|-------------------------|-------------|
|  | <b>June 30,</b>                      |             | <b>June 30,</b>         |             |
|  | <b>2007</b>                          | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
|  | (In thousands, except per unit data) |             |                         |             |
| <b>Revenues:</b>   |                                      |             |                         |             |
| Affiliates   | \$ 16,353                            | \$ 10,584   | \$ 30,115               | \$ 23,066   |
| Third parties  | 10,778                               | 7,943       | 20,888                  | 17,899      |
|  | 27,131                               | 18,527      | 51,003                  | 40,965      |
| <b>Operating costs and expenses:</b>                           |                                      |             |                         |             |
| Operations   | 8,263                                | 7,429       | 16,040                  | 14,538      |
| Depreciation and amortization                                  | 3,208                                | 3,781       | 7,279                   | 7,574       |
| General and administrative                                     | 1,275                                | 1,289       | 2,562                   | 2,513       |
|  | 12,746                               | 12,499      | 25,881                  | 24,625      |
| Operating income   | 14,385                               | 6,028       | 25,122                  | 16,340      |
| <b>Other income (expense):</b>                                 |                                      |             |                         |             |
| Interest income  | 145                                  | 245         | 330                     | 488         |
| Interest expense   | (3,371)                              | (3,247)     | (6,729)                 | (6,422)     |
| Gain on sale of assets   | 1                                    |             | 298                     |             |
|  | (3,225)                              | (3,002)     | (6,101)                 | (5,934)     |
| <b>Income before minority interest</b>                         | 11,160                               | 3,026       | 19,021                  | 10,406      |
| Minority interest in Rio Grande Pipeline Company               | (154)                                | (28)        | (581)                   | (273)       |
| <b>Net income</b>  | 11,006                               | 2,998       | 18,440                  | 10,133      |
| Less general partner interest in net income                    | 726                                  | 319         | 1,306                   | 646         |
| <b>Limited partners interest in net income</b>                 | \$ 10,280                            | \$ 2,679    | \$ 17,134               | \$ 9,487    |
| <b>Net income per limited partner unit - basic and diluted</b> | \$ 0.64                              | \$ 0.17     | \$ 1.06                 | \$ 0.59     |



|  |                          |        |        |        |        |
|--|--------------------------|--------|--------|--------|--------|
| <b>Weighted average limited partners</b> | <b>units outstanding</b> | 16,108 | 16,108 | 16,108 | 16,108 |
|--|--------------------------|--------|--------|--------|--------|

See accompanying notes.

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

|   | <b>Six Months Ended June 30,</b> |                  |
|---|----------------------------------|------------------|
|   | <b>2007</b>                      | <b>2006</b>      |
|   | (In thousands)                   |                  |
| <b>Cash flows from operating activities</b>                                       |                                  |                  |
| Net income  | \$ 18,440                        | \$ 10,133        |
| Adjustments to reconcile net income to net cash provided by operating activities: |                                  |                  |
| Depreciation and amortization   | 7,279                            | 7,574            |
| Minority interest in Rio Grande Pipeline Company                                  | 581                              | 273              |
| Amortization of restricted and performance units                                  | 763                              | 409              |
| Gain on sale of assets  | (298)                            |                  |
| (Increase) decrease in current assets:  |                                  |                  |
| Accounts receivable - trade   | 2,764                            | (759)            |
| Accounts receivable - affiliates  | (373)                            | 333              |
| Prepaid and other current assets  | 274                              | 172              |
| Increase (decrease) in current liabilities:                                       |                                  |                  |
| Accounts payable  | (1,909)                          | 398              |
| Accrued interest  | (9)                              | 32               |
| Deferred revenue  | (991)                            | 3,916            |
| Accrued property tax  | (254)                            | (188)            |
| Other current liabilities   | (377)                            | (12)             |
| Other, net  | 572                              | 205              |
| <b>Net cash provided by operating activities</b>                                  | <b>26,462</b>                    | <b>22,486</b>    |
| <b>Cash flows from investing activities</b>                                       |                                  |                  |
| Additions to properties and equipment   | (1,933)                          | (3,699)          |
| Proceeds from sale of assets  | 325                              |                  |
| <b>Net cash used for investing activities</b>                                     | <b>(1,608)</b>                   | <b>(3,699)</b>   |
| <b>Cash flows from financing activities</b>                                       |                                  |                  |
| Distributions to partners   | (23,382)                         | (21,244)         |
| Purchase of units for restricted grants   | (908)                            | (512)            |
| Cash distributions to minority interest   | (540)                            | (1,200)          |
| Other   | (16)                             |                  |
| <b>Net cash used for financing activities</b>                                     | <b>(24,846)</b>                  | <b>(22,956)</b>  |
| <b>Cash and cash equivalents</b>  |                                  |                  |
| Increase (decrease) for period  | 8                                | (4,169)          |
| Beginning of period   | 11,555                           | 20,583           |
| <b>End of period</b>  | <b>\$ 11,563</b>                 | <b>\$ 16,414</b> |

See accompanying notes.

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

|  | <b>Common<br/>Units</b> | <b>Subordinated<br/>Units</b> | <b>Class B<br/>Subordinated<br/>Units</b> | <b>General<br/>Partner<br/>Interest</b> | <b>Total</b> |
|--|-------------------------|-------------------------------|---|---|--------------|
|  |                         |                               | (In thousands)                            |   |              |
| Balance December 31, 2006                        | \$ 176,844              | \$ (70,022)                   | \$ 23,469                                 | \$ (94,065)                             | \$ 36,226    |
| Distributions to partners                        | (11,142)                | (9,555)                       | (1,280)                                   | (1,405)                                 | (23,382)     |
| Purchase of units for restricted grants          | (908)                   |                               |   |   | (908)        |
| Amortization of restricted and performance units | 763                     |                               |   |   | 763          |
| Net income                                       | 8,691                   | 7,446                         | 997                                       | 1,306                                   | 18,440       |
| Balance June 30, 2007                            | \$ 174,248              | \$ (72,131)                   | \$ 23,186                                 | \$ (94,164)                             | \$ 31,139    |

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 45% owned by Holly Corporation and its subsidiaries (collectively Holly ). HEP commenced operations July 13, 2004 upon the completion of its initial public offering. In this document, the words we , our , ours and us refer to HEP unless the context otherwise indicates.

We operate in one business segment the operation of petroleum pipelines and terminal facilities.

One of Holly s wholly-owned subsidiaries owns a refinery in Artesia, New Mexico, which Holly operates in conjunction with crude, vacuum distillation and other facilities situated in Lovington, New Mexico (collectively, the Navajo Refinery ). In July 2005, we acquired the two parallel intermediate feedstock pipelines which connect the Lovington, New Mexico and Artesia, New Mexico refining facilities. The Navajo Refinery produces high-value refined products such as gasoline, diesel fuel and jet fuel and serves markets in the southwestern United States and northern Mexico. We operate refined product pipelines as part of the product distribution network of the Navajo Refinery. Our terminal operations serving the Navajo Refinery include a truck rack at the Navajo Refinery and five integrated refined product terminals located in New Mexico, Texas and Arizona.

Another of Holly s wholly-owned subsidiaries owns a refinery located near Salt Lake City, Utah (the Woods Cross Refinery ). Our operations serving the Woods Cross Refinery include a truck rack at the Woods Cross Refinery, a refined product terminal in Spokane, Washington and a 50% non-operating interest in product terminals in Boise and Burley, Idaho.

In February 2005, we acquired from Alon USA, Inc. and several of its wholly-owned subsidiaries (collectively, Alon ) four refined products pipelines, an associated tank farm and two refined products terminals. These pipelines and terminals are located primarily in Texas and transport and terminal light refined products for Alon s refinery in Big Spring, Texas.

Additionally, we own a refined product terminal in Mountain Home, Idaho, and a 70% interest in Rio Grande Pipeline Company ( Rio Grande ), which provides transportation of liquid petroleum gases to northern Mexico.

The consolidated financial statements for the three and six months ended June 30, 2007 and 2006 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 accounting principles generally accepted in the United States of America 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, 2006. 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, 2007. Certain reclassifications have been made to prior reported amounts to conform to current classifications.

*Recent Accounting Pronouncements*

*Interpretation No. 48 Accounting for Uncertainty in Income Taxes*

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on

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derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We adopted this standard effective January 1, 2007. The adoption of this standard did not have a material impact on our financial condition, results of operations and cash flows.

**Note 2: Properties and Equipment**

|                               | <b>June 30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|-------------------------------|--------------------------|----------------------------------|
|                               | (In thousands)           |                                  |
| Pipelines and terminals       | \$ 196,308               | \$ 195,688                       |
| Land and right of way         | 22,825                   | 22,486                           |
| Other                         | 5,294                    | 5,267                            |
| Construction in progress      | 2,745                    | 1,539                            |
|                               | 227,172                  | 224,980                          |
| Less accumulated depreciation | 70,501                   | 64,496                           |
|                               | \$ 156,671               | \$ 160,484                       |

During the three and six months ended June 30, 2007 and 2006, we did not capitalize any interest related to major construction projects.

**Note 3: Transportation Agreements**

Our transportation agreements consist of the following:

Costs incurred by Rio Grande in constructing certain pipeline and terminal facilities located in Mexico, which were then contributed to an affiliate of Pemex, the national oil company of Mexico. In exchange, Rio Grande received a 10-year transportation agreement from BP plc ( BP ). The initial 10-year term of this agreement expired in April 2007 and was extended for an additional year. This agreement will continue on a year-to-year basis unless cancelled by either party prior to the end of the previous contract year. The carrying amount of this asset was fully amortized and retired as of June 30, 2007.

A portion of the total purchase price of the Alon assets was allocated to the transportation agreement asset based on an estimated fair value derived under the income approach. This asset is being amortized over 30 years ending 2035, the 15-year initial term of the pipelines and terminals agreement with Alon plus the expected 15-year extension period.

The carrying amounts of our transportation agreements are as follows:

|                                     | <b>June<br/>30,<br/>2007</b> | <b>December<br/>31,<br/>2006</b> |
|-------------------------------------|------------------------------|----------------------------------|
|                                     | (In thousands)               |                                  |
| Rio Grande transportation agreement | \$                           | \$ 20,836                        |
| Alon transportation agreement       | 59,933                       | 59,933                           |
|                                     | 59,933                       | 80,769                           |
| Less accumulated amortization       | 4,661                        | 23,948                           |
|                                     | \$ 55,272                    | \$ 56,821                        |

**Note 4: Debt**

***Credit Agreement***

We have a four-year, \$100.0 million senior secured revolving credit agreement (the Credit Agreement ) expiring in July 2008. Union Bank of California, N.A. is one of the lenders and serves as administrative agent under this agreement. As of June 30, 2007 and December 31, 2006, we had no amounts outstanding under the Credit Agreement.

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The Credit Agreement is available to fund capital expenditures, acquisitions, and working capital and for general partnership purposes. Advances under the Credit Agreement that are designated for working capital are short-term liabilities. Other advances under the Credit Agreement are classified as long-term liabilities. In addition, the Credit Agreement is available to fund letters of credit up to a \$50.0 million sub-limit. Up to \$5.0 million is available to fund distributions to unitholders.

We have the right to request an increase in the maximum amount of the Credit Agreement, up to \$175.0 million. Such request will become effective if (a) certain conditions specified in the Credit Agreement are met and (b) existing lenders under the Credit Agreement or other financial institutions reasonably acceptable to the administrative agent commit to lend such increased amounts under the agreement.

Our obligations under the Credit Agreement are secured by substantially all of our assets. Indebtedness under the Credit Agreement is recourse to HEP Logistics Holdings, L.P., our general partner, and guaranteed by our wholly-owned subsidiaries.

We may prepay all loans at any time without penalty. We are required to reduce all working capital borrowings under the Credit Agreement to zero for a period of at least 15 consecutive days once each twelve-month period prior to the maturity date of the agreement.

Indebtedness under the Credit Agreement bears interest, at our option, at either (a) the base rate as announced by the administrative agent plus an applicable margin (ranging from 0.25% to 1.00%) or (b) at a rate equal to the London Interbank Offered Rate ( LIBOR ) plus an applicable margin (ranging from 1.50% to 2.25%). In each case, the applicable margin is based upon the ratio of our funded debt (as defined in the agreement) to EBITDA (earnings before interest, taxes, depreciation and amortization, as defined in the Credit Agreement). We incur a commitment fee on the unused portion of the Credit Agreement at a rate of 0.375% or 0.500% based upon the ratio of our funded debt to EBITDA for the four most recently completed fiscal quarters. At June 30, 2007, we are subject to the 0.500% rate on the \$100.0 million of the unused commitment on the Credit Agreement. The agreement matures in July 2008. At that time, the agreement will terminate and all outstanding amounts thereunder will be due and payable.

The Credit Agreement imposes certain requirements, 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 EBITDA to interest expense ratio and debt to EBITDA ratio. If an event of default exists under the agreement, the lenders will be able to accelerate the maturity of the debt and exercise other rights and remedies.

***Senior Notes Due 2015***

Our senior notes maturing March 1, 2015 are registered with the SEC and bear interest at 6.25% ( Senior Notes ). The Senior Notes are unsecured and impose certain restrictive covenants, 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.

The \$185.0 million principal amount of Senior Notes is recorded at \$181.4 million on our consolidated balance sheets at June 30, 2007. The difference of \$3.6 million is due to \$2.9 million of unamortized discount and \$0.7 million relating to the fair value of the interest rate swap contract discussed below.



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We have entered into an interest rate swap contract to effectively convert the interest expense associated with \$60.0 million of our 6.25% Senior Notes from a fixed rate to a variable rate. The interest rate on the \$60.0 million notional amount is equal to three-month LIBOR plus an applicable margin of 1.1575%, which equaled an effective interest rate of 6.56% on \$60.0 million of the debt during the six months ended June 30, 2007. The maturity of the swap contract is March 1, 2015, matching the maturity of the Senior Notes.

This interest rate swap has been designated as a fair value hedge as defined by SFAS No. 133. Our interest rate swap meets the conditions required to assume no ineffectiveness under SFAS No. 133 and, therefore, we have used the shortcut method of accounting prescribed for fair value hedges by Statement of Financial Accounting Standard ( SFAS ) No. 133. Accordingly, we adjust the carrying value of the swap to its fair value each quarter, with an offsetting entry to adjust the carrying value of the debt securities whose fair value is being hedged. We record interest expense equal to the variable rate payments under the swap.

The fair value of our interest rate swap of \$0.7 million and \$1.2 million is included in Other long-term liabilities in our consolidated balance sheets at June 30, 2007 and December 31, 2006, respectively. The offsetting entry to adjust the carrying value of the debt securities whose fair value is being hedged is recognized as a reduction of Long-term debt on our consolidated balance sheets at June 30, 2007 and December 31, 2006.

**Other Debt Information**

|  | <b>Six Months Ended<br/>June 30,</b> |             |
|--|--------------------------------------|-------------|
|  | <b>2007</b>                          | <b>2006</b> |
|  | (In thousands)                       |             |
| Interest on outstanding debt:                        |                                      |             |
| Senior Notes, net of interest rate swap              | \$ 5,874                             | \$ 5,690    |
| Amortization of discount and deferred issuance costs | 607                                  | 484         |
| Commitment fees                                      | 248                                  | 248         |
| Net interest expense                                 | \$ 6,729                             | \$ 6,422    |
| Cash paid for interest <sup>(1)</sup>                | \$ 6,259                             | \$ 5,906    |

(1) Net of cash received under our interest rate swap agreement of \$1.9 million for the six months ended June 30, 2007 and 2006.

The estimated fair value of our Senior Notes was \$173.0 million at June 30, 2007.

**Note 5: Employees, Retirement and Benefit 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 under certain provisions of an omnibus agreement we entered into with Holly in July 2004 (the Omnibus Agreement ).

These employees participate in the retirement and benefit plans of Holly. Our share of retirement and benefits costs was \$0.4 million for the three months ended June 30, 2007 and 2006 and \$0.8 million and \$0.6 million for the six months ended June 30 2007 and 2006, respectively.

We have adopted a Long-Term Incentive Plan for employees, consultants and 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.

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On June 30, 2007, we had two types of equity-based compensation, which are described below. The compensation cost charged against income for these plans was \$0.5 million and \$0.2 million for the three months ended June 30, 2007 and 2006, respectively, and \$0.8 million and \$0.4 million for the six months ended June 30, 2007 and 2006, respectively. It is currently our policy to purchase units in the open market instead of issuing new units for settlement of restricted unit grants. At June 30, 2007, 350,000 units were authorized to be granted under the equity-based compensation plans, of which 253,255 had not yet been granted.

**Restricted Units**

Under our Long-Term Incentive Plan, we grant restricted units to selected employees, consultants 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 vesting for certain key executives is contingent upon certain earnings per unit targets being realized. The fair value of each unit of restricted unit awards was measured at the market price as of the date of grant and is being amortized over the vesting period, including the units issued to the key executives, as we expect those units to fully vest.

A summary of restricted unit activity as of June 30, 2007, and changes during the six months ended June 30, 2007, is presented below:

| <b>Restricted Units</b>                              | <b>Grants</b> | <b>Weighted-Average Grant-Date Fair Value</b> | <b>Weighted-Average Remaining Contractual Term</b> | <b>Aggregate Intrinsic Value (\$000)</b> |
|--|---------------|---|--|--|
| Outstanding January 1, 2007 (not vested)             | 36,597        | 40.21   |  |  |
| Granted  | 19,687        | 46.12   |  |  |
| Forfeited  | (1,555)       | 45.94   |  |  |
| Vesting and transfer of full ownership to recipients | (4,170)       | 39.45   |  |  |
| Outstanding at June 30, 2007 (not vested)            | 50,559        | \$ 42.02                                      | 1.1 years  | \$ 2,573                                 |

There were 4,170 units vested and transferred to recipients during the six months ended June 30, 2007. As of June 30, 2007, there was \$0.8 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 1.1 years.

**Performance Units**

Under our Long-Term Incentive Plan, we grant performance units to selected executives and employees who perform services for us. These performance units are payable upon meeting the performance criteria over a service period, and generally vest over a period of three years. The amount payable under the initial performance grant of 1,514 units in 2005 is based upon our unit price and upon our total unitholder return during the requisite period as compared to the total unitholder return of a selected peer group of partnerships. The amount payable under all other performance unit grants is based upon the growth in distributions per limited partner unit during the requisite period.

We granted 12,321 performance units to certain officers in February 2007. These units will vest over a three-year performance period ending December 31, 2009, and are payable in HEP common units. The number of units actually earned will be based on the growth of distributions to limited partners over the performance period, and can range from 50% to 150% of the number of performance units issued. The fair value of these performance units is based on the grant date closing unit price of \$46.12 and will apply to the number of units ultimately awarded.

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A summary of performance units activity as of June 30, 2007 and changes during the six months ended June 30, 2007 is presented below:

| <b>Performance Units</b>                          | <b>Payable<br/>In Units</b> |
|---|-----------------------------|
| Outstanding at January 1, 2007 (not vested)       | 14,015                      |
| Vesting and payment of cash benefit to recipients |                             |
| Granted   | 12,321                      |
| Forfeited   | (2,188)                     |
| Outstanding at June 30, 2007 (not vested)         | 24,148                      |

There were no payments for performance units vesting during the six months ended June 30, 2007. Based on the weighted average fair value at June 30, 2007 of \$47.62, there was \$0.6 million of total unrecognized compensation cost related to nonvested performance units. That cost is expected to be recognized over a weighted-average period of 1.9 years.

**Note 6: Significant Customers**

All revenues are domestic revenues, of which over 90% are currently generated from our three largest customers: Holly, Alon and BP. The major concentration of our petroleum products pipeline system's revenue is derived from activities conducted in the southwest United States. The following table presents the percentage of total revenues generated by each of these three customers:

|       | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|-------|---------------------------|-------------|-------------------------|-------------|
|       | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|       | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
| Holly | 60%                       | 57%         | 59%                     | 56%         |
| Alon  | 29%                       | 30%         | 28%                     | 30%         |
| BP    | 7%                        | 9%          | 10%                     | 10%         |

**Note 7: Related Party Transactions****Holly**

We serve Holly's refineries in New Mexico and Utah under two 15-year pipeline and terminal agreements. One of these agreements relates to the pipelines and terminals contributed by Holly to us at the time of our initial public offering and expires in 2019 (Holly PTA). Our other agreement with Holly relates to the Intermediate Pipelines acquired from Holly in July 2005 and expires in 2020 (Holly IPA). The substantial majority of our business is devoted to providing transportation and terminalling services to Holly. The minimum revenue commitments under the Holly PTA and the Holly IPA increase each year at a rate equal to the percentage change in the producer price index (PPI), but will not decrease as a result of a decrease in the PPI.

Following the July 1, 2007 PPI rate adjustment, the volume commitments by Holly under the Holly PTA will produce at least \$39.6 million of revenue for the twelve months ending June 30, 2008. Under the Holly IPA, Holly agreed to transport volumes of intermediate products on the Intermediate Pipelines that following the July 1, 2007 PPI rate adjustment, will result in minimum funds to us of \$12.8 million for the twelve months ended June 30, 2008.

If Holly fails to meet its minimum revenue commitments in any quarter, it is required to pay us in cash the amount of any shortfall by the last day of the month following the end of the quarter. A shortfall payment may be applied as a credit in the following four quarters after Holly's minimum obligations are met.

Under certain provisions of the Omnibus Agreement that we entered with Holly in July 2004 and expires in 2019, we pay Holly an annual administrative fee, initially \$2.0 million for each of the three years following the closing of our initial public offering, for the provision by Holly or its affiliates of various

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general and administrative services to us. Effective July 1, 2007, the annual fee increased to \$2.3 million in accordance with provisions under the agreement. This fee does not include the salaries of pipeline and terminal personnel or the cost of their employee benefits, such as 401(k), pension and health insurance benefits, which are separately charged to us by Holly. We also reimburse Holly and its affiliates for direct expenses they incur on our behalf.

Pipeline and terminal revenues received from Holly were \$16.4 million and \$10.6 million for the three months ended June 30, 2007 and 2006, respectively, and \$30.1 million and \$23.1 million for the six months ended June 30, 2007 and 2006, respectively. These amounts include the revenues received under the Holly PTA and Holly IPA.

Holly charged general and administrative services under the Omnibus Agreement of \$0.5 million for the three months ended June 30, 2007 and 2006 and \$1.0 million for the six months ended June 30, 2007 and 2006.

We reimbursed Holly for costs of employees supporting our operations of \$2.3 million and \$1.8 million for the three months ended June 30, 2007 and 2006, respectively, and \$4.6 million and \$3.7 million for the six months ended June 30, 2007 and 2006, respectively.

Holly reimbursed us \$24,000 and \$40,000 for certain costs paid on their behalf for the three months ended June 30, 2007 and 2006, respectively, and \$98,000 and \$96,000 for the six months ended June 30, 2007 and 2006, respectively.

In the three months ended June 30, 2007 and 2006, we distributed \$5.6 million and \$5.0 million, respectively, to Holly as regular distributions on its subordinated units, common units and general partner interest. We distributed \$11.1 million and \$9.8 million to Holly in the six months ended June 30, 2007 and 2006, respectively.

Our net accounts receivable from Holly were \$3.9 million and \$3.5 million at June 30, 2007 and December 31, 2006, respectively.

Holly has failed to meet its minimum revenue commitment for each of the first eight quarters of the Holly IPA. We have charged Holly \$4.1 million for these shortfalls to date, \$0.2 million of which is included in affiliate accounts receivable at June 30, 2007 and December 31, 2006.

For the three and six months ended June 30, 2007, our revenues from Holly included \$1.1 million and \$1.6 million, respectively, of shortfalls billed under the Holly IPA in 2006 as Holly did not exceed its minimum revenue obligation in any of the subsequent four quarters. Deferred revenue in the consolidated balance sheets at June 30, 2007 and December 31, 2006, includes \$1.5 million and \$2.4 million, respectively, relating to the Holly IPA. It is possible that Holly may not exceed its minimum obligations under the Holly IPA to allow Holly to receive credit for any of the \$1.5 million deferred at June 30, 2007.

***BP***

We have a 70% ownership interest in Rio Grande and BP owns the other 30%. Due to the ownership interest and resulting consolidation, BP is a related party to us.

BP is the sole customer of Rio Grande. BP's agreement to ship on the Rio Grande pipeline expired in April 2007 and was extended for an additional year. This agreement will continue on a year-to-year basis unless cancelled by either party prior to the end of the previous contract year. We recorded revenues from them of \$1.8 million and \$1.6 million for the three months ended June 30, 2007 and 2006, respectively, and \$4.8 million and \$4.0 million for the six months ended June 30, 2007 and 2006, respectively.

Rio Grande paid distributions to BP of \$0.5 million and \$0.6 million for the three months ended June 30, 2007 and 2006, respectively, and \$0.5 million and \$1.2 million for the six months ended June 30, 2007 and 2006, respectively.



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Included in our accounts receivable trade at June 30, 2007 and December 31, 2006 were \$0.4 million and \$2.1 million, respectively, which represented the receivable balance of Rio Grande from BP.

***Alon***

We have a 15-year pipelines and terminals agreement with Alon (the Alon PTA), expiring in 2020, under which Alon has agreed to transport on our pipelines and throughput through our terminals volumes of refined products that results in a minimum level of annual revenue. The agreed upon tariffs are increased or decreased annually at a rate equal to the percentage change in PPI, but not below the initial tariff rate. Following the March 1, 2007 PPI rate adjustment, Alon's total minimum commitment for the twelve months ending December 31, 2007 is \$20.8 million.

Alon became a related party when it acquired all of our Class B subordinated units in connection with our acquisition of assets from them on February 28, 2005.

We recognized \$6.2 million and \$5.6 million of revenues for pipeline transportation and terminalling services under the Alon PTA and \$1.8 million and \$1.7 million under a pipeline capacity lease for the three months ended June 30, 2007 and 2006, respectively. We recognized \$10.7 million and \$12.4 million of revenues for pipeline transportation and terminalling services under the Alon PTA and \$3.5 million and \$3.4 million under a pipeline capacity lease for the six months ended June 30, 2007 and 2006, respectively. The capacity lease agreements have remaining terms from less than a year up to three years.

We paid \$0.7 million and \$0.6 million to Alon for distributions on our Class B subordinated units for the three months ended June 30, 2007 and 2006, respectively, and \$1.3 million and \$1.2 million for the six months ended June 30, 2007 and 2006, respectively.

Included in our accounts receivable trade at June 30, 2007 and December 31, 2006 were \$4.4 million and \$5.0 million, respectively, which represented the receivable balance from Alon.

For the three and six months ended June 30, 2007, our revenues from Alon included \$1.5 million of shortfalls billed under the Alon PTA in 2006 as Alon did not exceed its minimum revenue obligation in any of the subsequent four quarters. Deferred revenue in the consolidated balance sheets at June 30, 2007 and December 31, 2006 includes \$3.0 million and \$3.1 million, respectively, relating to the Alon PTA. It is possible that Alon may not exceed its minimum obligations under the Alon PTA to allow Alon to receive credit for any of the \$3.0 million deferred at June 30, 2007.

**Note 8: Partners Equity and Cash Distributions**

***Issuances of units***

Holly currently holds 7,000,000 of our subordinated units and 70,000 of our common units, which constitutes a 45% ownership interest in us, including the 2% general partner interest.

Holly's subordinated units have the right to receive distributions of available cash from operating surplus in an amount equal to the minimum quarterly distribution of \$0.50 per quarter, plus any arrearages in the payment of the minimum quarterly distribution on the common units from prior quarters, before any distributions of available cash from operating surplus may be made on the subordinated units. The purpose of the subordinated units is to increase the likelihood that cash is available for common unit distributions during the subordination period. The subordination period will extend until the first day of any quarter beginning after June 30, 2009 that each of the following tests are met: distributions of available cash from operating surplus on each of the outstanding common units and subordinated units equaled or exceeded the minimum quarterly distribution for each of the three consecutive, non-overlapping four-quarter periods immediately preceding that date; the adjusted operating surplus (as defined in its partnership agreement) generated during each of the three consecutive, non-overlapping

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four-quarter periods immediately preceding that date equaled or exceeded the sum of the minimum quarterly distributions on all of the outstanding common units and subordinated units during those periods on a fully diluted basis and the related distribution on the 2% general partner interest during those periods; and there are no arrearages in payment of the minimum quarterly distribution on the common units. If the unitholders remove the general partner without cause, the subordination period may end before June 30, 2009. The Holly subordinated units may convert to common units on a one-for-one basis when certain conditions are met. The partnership agreement sets forth the calculation to be used to determine the amount and priority of cash distributions that the common unitholders, subordinated unitholders and general partner will receive.

Under our registration statement filed with the SEC using a shelf registration process, we may offer from time to time up to \$800.0 million of our securities, through one or more prospectus supplements that would describe, among other things, the specific amounts, prices and terms of any securities offered and how the proceeds would be used. Any proceeds from the sale of securities would be used for general business purposes, which may include, among other things, funding acquisitions of assets or businesses, working capital, capital expenditures, investments in subsidiaries, the retirement of existing debt and/or the repurchase of common units or other securities.

***Allocations of Net Income***

Net income is allocated between limited partners and the general partner interest in accordance with the provisions of the partnership agreement. Net income allocated to the general partner includes any incentive distributions declared in the period. After the amount of incentive distributions is allocated to the general partner, the remaining net income for the period is generally allocated to the partners based on their weighted average ownership percentage during the period.

***Cash Distributions***

We consider regular cash distributions to unitholders on a quarterly basis, although there is no assurance as to the future cash distributions since they are dependent upon future earnings, cash flows, capital requirements, financial condition and other factors. Our Credit Agreement prohibits us from making cash distributions if any potential default or event of default, as defined in the Credit Agreement, occurs or would result from the cash distribution.

Within 45 days after the end of each quarter, we will distribute all of our available cash (as defined in our partnership agreement) to unitholders of record on the applicable record date. The amount of available cash generally is all cash on hand at the end of the quarter; less the amount of cash reserves established by our general partner to provide for the proper conduct of our business, comply with applicable law, any of our debt instruments, or other agreements; or provide funds for distributions to our unitholders and to our general partner for any one or more of the next four quarters; plus all cash on hand on the date of determination of available cash for the quarter resulting from working capital borrowings made after the end of the quarter. Working capital borrowings are generally borrowings that are made under our revolving Credit Agreement and in all cases are used solely for working capital purposes or to pay distributions to partners.

We make distributions of available cash from operating surplus for any quarter during any subordination period in the following manner: firstly, 98% to the common unitholders, pro rata, and 2% to the general partner, until we distribute for each outstanding common unit an amount equal to the minimum quarterly distribution for that quarter; secondly, 98% to the common unitholders, pro rata, and 2% to the general partner, until we distribute for each outstanding common unit an amount equal to any arrearages in payment of the minimum quarterly distribution on the common units for any prior quarters during the subordination period; thirdly, 98% to the subordinated unitholders, pro rata, and 2% to the general partner, until we distribute for each subordinated unit an amount equal to the minimum quarterly distribution for that quarter; and thereafter, cash in excess of the minimum quarterly distributions is distributed to the unitholders and the general partner based on the percentages below.



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The general partner, HEP Logistics Holdings, L.P., is entitled to incentive distributions if the amount we distribute with respect to any quarter exceeds specified target levels shown below:

|                                | Total Quarterly Distribution<br>Target Amount | Marginal Percentage Interest<br>in<br>Distributions |                 |
|--------------------------------|---|---|-----------------|
|                                |   | Unitholders   | General Partner |
| Minimum Quarterly Distribution | \$0.50  | 98%   | 2%              |
| First Target Distribution      | Up to \$0.55                                  | 98%   | 2%              |
| Second Target Distribution     | above \$0.55 up to \$0.625                    | 85%   | 15%             |
| Third Target distribution      | above \$0.625 up to \$0.75                    | 75%   | 25%             |
| Thereafter                     | Above \$0.75                                  | 50%   | 50%             |

The following table presents the allocation of our regular quarterly cash distributions to the general and limited partners for each period in which declared.

|   | Three Months Ended<br>June 30,       |           | Six Months Ended<br>June 30, |           |
|---|--------------------------------------|-----------|------------------------------|-----------|
|   | 2007                                 | 2006      | 2007                         | 2006      |
|   | (In thousands, except per unit data) |           |                              |           |
| General partner interest                                  | \$ 227                               | \$ 210    | \$ 449                       | \$ 416    |
| General partner incentive distribution                    | 516                                  | 264       | 956                          | 453       |
| Total general partner distribution                        | 743                                  | 474       | 1,405                        | 869       |
| Limited partner distribution                              | 11,101                               | 10,309    | 21,977                       | 20,375    |
| Total regular quarterly cash distribution                 | \$ 11,844                            | \$ 10,783 | \$ 23,382                    | \$ 21,244 |
| Cash distribution per unit applicable to limited partners | \$ 0.69                              | \$ 0.64   | \$ 1.365                     | \$ 1.265  |

On July 26, 2007, we announced a cash distribution for the second quarter of 2007 of \$0.705 per unit. The distribution is payable on all common, subordinated, and general partner units and will be paid August 14, 2007 to all unitholders of record on August 6, 2007. The aggregate amount of the distribution will be \$12.2 million, including \$0.6 million paid to the general partner as an incentive distribution.

As a master limited partnership, we distribute our available cash, which exceeds our net income because depreciation and amortization expense represents a non-cash charge against income. The result is a decline in partners' equity since our regular quarterly distributions exceed our quarterly net income.

**Note 9: Supplemental Guarantor/Non-Guarantor Financial Information**

Obligations of Holly Energy Partners, L.P. ( Parent ) under the 6.25% 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. Rio Grande ( Non-Guarantor ), in which we have a 70% ownership interest, is the only subsidiary, which has not guaranteed these obligations.

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



**Table of Contents****Condensed Consolidating Balance Sheet**

| <b>June 30, 2007</b>                       | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Non-<br/>Guarantor</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|--|---------------|-----------------------------------|---------------------------|---------------------|---------------------|
|  |               |                                   | (in thousands)            |                     |                     |
| <b>ASSETS</b>                              |               |                                   |                           |                     |                     |
| Current assets:                            |               |                                   |                           |                     |                     |
| Cash and cash equivalents                  | \$ 2          | \$ 7,099                          | \$ 4,462                  | \$                  | \$ 11,563           |
| Accounts receivable                        |               | 8,054                             | 412                       |                     | 8,466               |
| Intercompany accounts receivable (payable) | (109,671)     | 109,878                           | (207)                     |                     |                     |
| Prepaid and other current assets           | 6             | 932                               |                           |                     | 938                 |
| Total current assets                       | (109,663)     | 125,963                           | 4,667                     |                     | 20,967              |
| Properties and equipment, net              |               | 124,098                           | 32,573                    |                     | 156,671             |
| Investment in subsidiaries                 | 324,956       | 25,675                            |                           | (350,631)           |                     |
| Transportation agreements, net             |               | 55,272                            |                           |                     | 55,272              |
| Other assets                               | 1,378         | 901                               |                           |                     | 2,279               |
| Total assets                               | \$ 216,671    | \$ 331,909                        | \$ 37,240                 | \$ (350,631)        | \$ 235,189          |

**LIABILITIES AND PARTNERS****EQUITY**

|                                       |            |            |           |              |            |
|---------------------------------------|------------|------------|-----------|--------------|------------|
| Current liabilities:                  |            |            |           |              |            |
| Accounts payable                      | \$         | \$ 1,480   | \$ 392    | \$           | \$ 1,872   |
| Accrued interest                      | 2,930      | 2          |           |              | 2,932      |
| Deferred revenue                      |            | 4,495      |           |              | 4,495      |
| Accrued property taxes                |            | 527        | 87        |              | 614        |
| Other current liabilities             | 516        | 122        | 83        |              | 721        |
| Total current liabilities             | 3,446      | 6,626      | 562       |              | 10,634     |
| Long-term debt                        | 181,443    |            |           |              | 181,443    |
| Other long-term liabilities           | 643        | 327        |           |              | 970        |
| Minority interest                     |            |            |           | 11,003       | 11,003     |
| Partners equity                       | 31,139     | 324,956    | 36,678    | (361,634)    | 31,139     |
| Total liabilities and partners equity | \$ 216,671 | \$ 331,909 | \$ 37,240 | \$ (350,631) | \$ 235,189 |

**Condensed Consolidating Balance Sheet**

| <b>December 31, 2006</b>  | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Non-<br/>Guarantor</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---------------------------|---------------|-----------------------------------|---------------------------|---------------------|---------------------|
|                           |               |                                   | (in thousands)            |                     |                     |
| <b>ASSETS</b>             |               |                                   |                           |                     |                     |
| Current assets:           |               |                                   |                           |                     |                     |
| Cash and cash equivalents | \$ 2          | \$ 9,819                          | \$ 1,734                  | \$                  | \$ 11,555           |
| Accounts receivable       |               | 8,772                             | 2,085                     |                     | 10,857              |

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|  |            |            |           |              |            |
|--|------------|------------|-----------|--------------|------------|
| Intercompany accounts receivable (payable) | (78,952)   | 79,144     | (192)     |              |            |
| Prepaid and other current assets           | 203        | 1,009      |           |              | 1,212      |
| Total current assets                       | (78,747)   | 98,744     | 3,627     |              | 23,624     |
| Properties and equipment, net              |            | 127,357    | 33,127    |              | 160,484    |
| Investment in subsidiaries                 | 298,872    | 25,581     |           | (324,453)    |            |
| Transportation agreements, net             |            | 56,271     | 550       |              | 56,821     |
| Other assets                               | 1,453      | 1,191      |           |              | 2,644      |
| Total assets                               | \$ 221,578 | \$ 309,144 | \$ 37,304 | \$ (324,453) | \$ 243,573 |

**LIABILITIES AND PARTNERS  
EQUITY**

|                                       |            |            |           |              |            |
|---------------------------------------|------------|------------|-----------|--------------|------------|
| Current liabilities:                  |            |            |           |              |            |
| Accounts payable                      | \$         | \$ 3,356   | \$ 425    | \$           | \$ 3,781   |
| Accrued interest                      | 2,941      |            |           |              | 2,941      |
| Deferred revenue                      |            | 5,486      |           |              | 5,486      |
| Accrued property taxes                |            | 726        | 142       |              | 868        |
| Other current liabilities             | 516        | 389        | 193       |              | 1,098      |
| Total current liabilities             | 3,457      | 9,957      | 760       |              | 14,174     |
| Long-term debt                        | 180,660    |            |           |              | 180,660    |
| Other long-term liabilities           | 1,235      | 315        |           |              | 1,550      |
| Minority interest                     |            |            |           | 10,963       | 10,963     |
| Partners equity                       | 36,226     | 298,872    | 36,544    | (335,416)    | 36,226     |
| Total liabilities and partners equity | \$ 221,578 | \$ 309,144 | \$ 37,304 | \$ (324,453) | \$ 243,573 |

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**Table of Contents****Condensed Consolidating Statement of Income**

| <b>Three months ended June 30, 2007</b> | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Non-<br/>Guarantor</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---------------|-----------------------------------|---------------------------|---------------------|---------------------|
|   |               |                                   |                           |                     | (in thousands)      |
| Revenues:                               |               |                                   |                           |                     |                     |
| Affiliates                              | \$            | \$ 16,353                         | \$                        | \$                  | \$ 16,353           |
| Third parties                           |               | 9,258                             | 1,820                     | (300)               | 10,778              |
|   |               | 25,611                            | 1,820                     | (300)               | 27,131              |
| Operating costs and expenses:           |               |                                   |                           |                     |                     |
| Operations                              |               | 7,601                             | 962                       | (300)               | 8,263               |
| Depreciation and amortization           |               | 2,851                             | 357                       |                     | 3,208               |
| General and administrative              | 739           | 515                               | 21                        |                     | 1,275               |
|   | 739           | 10,967                            | 1,340                     | (300)               | 12,746              |
| Operating income (loss)                 | (739)         | 14,644                            | 480                       |                     | 14,385              |
| Equity in earnings of subsidiaries      | 14,820        | 356                               |                           | (15,176)            |                     |
| Interest income (expense)               | (3,075)       | (181)                             | 30                        |                     | (3,226)             |
| Gain on sale of assets                  |               | 1                                 |                           |                     | 1                   |
| Minority interest                       |               |                                   |                           | (154)               | (154)               |
| Net income                              | \$ 11,006     | \$ 14,820                         | \$ 510                    | \$ (15,330)         | \$ 11,006           |

**Condensed Consolidating Statement of Income**

| <b>Three months ended June 30, 2006</b> | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Non-<br/>Guarantor</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|---------------|-----------------------------------|---------------------------|---------------------|---------------------|
|   |               |                                   |                           |                     | (in thousands)      |
| Revenues:                               |               |                                   |                           |                     |                     |
| Affiliates                              | \$            | \$ 10,584                         | \$                        | \$                  | \$ 10,584           |
| Third parties                           |               | 6,607                             | 1,637                     | (301)               | 7,943               |
|   |               | 17,191                            | 1,637                     | (301)               | 18,527              |
| Operating costs and expenses:           |               |                                   |                           |                     |                     |
| Operations                              |               | 7,006                             | 724                       | (301)               | 7,429               |
| Depreciation and amortization           |               | 2,934                             | 847                       |                     | 3,781               |
| General and administrative              | 777           | 510                               | 2                         |                     | 1,289               |
|   | 777           | 10,450                            | 1,573                     | (301)               | 12,499              |
| Operating income (loss)                 | (777)         | 6,741                             | 64                        |                     | 6,028               |
| Equity in earnings of subsidiaries      | 6,788         | 65                                |                           | (6,853)             |                     |

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|                           |          |          |       |            |          |
|---------------------------|----------|----------|-------|------------|----------|
| Interest income (expense) | (3,013)  | (18)     | 29    |            | (3,002)  |
| Minority interest         |          |          |       | (28)       | (28)     |
| Net income                | \$ 2,998 | \$ 6,788 | \$ 93 | \$ (6,881) | \$ 2,998 |

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**Table of Contents****Condensed Consolidating Statement of Income**

| <b>Six months ended June 30, 2007</b> | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Non-<br/>Guarantor</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---------------------------------------|---------------|-----------------------------------|---------------------------|---------------------|---------------------|
|                                       |               |                                   |                           |                     |                     |
|                                       |               |                                   |                           |                     | (in thousands)      |
| Revenues:                             |               |                                   |                           |                     |                     |
| Affiliates                            | \$            | \$ 30,115                         | \$                        | \$                  | \$ 30,115           |
| Third parties                         |               | 16,635                            | 4,846                     | (593)               | 20,888              |
|                                       |               | 46,750                            | 4,846                     | (593)               | 51,003              |
| Operating costs and expenses:         |               |                                   |                           |                     |                     |
| Operations                            |               | 14,878                            | 1,755                     | (593)               | 16,040              |
| Depreciation and amortization         |               | 6,074                             | 1,205                     |                     | 7,279               |
| General and administrative            | 1,505         | 1,035                             | 22                        |                     | 2,562               |
|                                       | 1,505         | 21,987                            | 2,982                     | (593)               | 25,881              |
| Operating income (loss)               | (1,505)       | 24,763                            | 1,864                     |                     | 25,122              |
| Equity in earnings of subsidiaries    | 26,084        | 1,353                             |                           | (27,437)            |                     |
| Interest income (expense)             | (6,139)       | (330)                             | 70                        |                     | (6,399)             |
| Gain on sale of assets                |               | 298                               |                           |                     | 298                 |
| Minority interest                     |               |                                   |                           | (581)               | (581)               |
| Net income                            | \$ 18,440     | \$ 26,084                         | \$ 1,934                  | \$ (28,018)         | \$ 18,440           |

**Condensed Consolidating Statement of Income**

| <b>Six months ended June 30, 2006</b> | <b>Parent</b> | <b>Guarantor<br/>Subsidiaries</b> | <b>Non-<br/>Guarantor</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---------------------------------------|---------------|-----------------------------------|---------------------------|---------------------|---------------------|
|                                       |               |                                   |                           |                     |                     |
|                                       |               |                                   |                           |                     | (in thousands)      |
| Revenues:                             |               |                                   |                           |                     |                     |
| Affiliates                            | \$            | \$ 23,066                         | \$                        | \$                  | \$ 23,066           |
| Third parties                         |               | 14,488                            | 4,006                     | (595)               | 17,899              |
|                                       |               | 37,554                            | 4,006                     | (595)               | 40,965              |
| Operating costs and expenses:         |               |                                   |                           |                     |                     |
| Operations                            |               | 13,676                            | 1,457                     | (595)               | 14,538              |
| Depreciation and amortization         |               | 5,883                             | 1,691                     |                     | 7,574               |
| General and administrative            | 1,489         | 1,021                             | 3                         |                     | 2,513               |
|                                       | 1,489         | 20,580                            | 3,151                     | (595)               | 24,625              |
| Operating income (loss)               | (1,489)       | 16,974                            | 855                       |                     | 16,340              |
| Equity in earnings of subsidiaries    | 17,577        | 637                               |                           | (18,214)            |                     |

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|                           |           |           |        |             |           |
|---------------------------|-----------|-----------|--------|-------------|-----------|
| Interest income (expense) | (5,955)   | (34)      | 55     |             | (5,934)   |
| Minority interest         |           |           |        | (273)       | (273)     |
| Net income                | \$ 10,133 | \$ 17,577 | \$ 910 | \$ (18,487) | \$ 10,133 |

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**Table of Contents****Condensed Consolidating Statement of Cash Flows**

| <b>Six months ended June 30, 2007</b>   | <b>Parent</b>  | <b>Guarantor<br/>Subsidiaries</b> | <b>Non-<br/>Guarantor</b> | <b>Elimination</b> | <b>Consolidated</b> |
|---|----------------|-----------------------------------|---------------------------|--------------------|---------------------|
|   | (in thousands) |                                   |                           |                    |                     |
| Cash flows from operating activities    | \$ 24,290      | \$ (1,196)                        | \$ 4,628                  | \$ (1,260)         | \$ 26,462           |
| Cash flows from investing activities    |                |                                   |                           |                    |                     |
| Additions to properties and equipment   |                | (1,833)                           | (100)                     |                    | (1,933)             |
| Proceeds from sale of assets            |                | 325                               |                           |                    | 325                 |
|   |                | (1,508)                           | (100)                     |                    | (1,608)             |
| Cash flows from financing activities    |                |                                   |                           |                    |                     |
| Distributions to partners               | (23,382)       |                                   | (1,800)                   | 1,800              | (23,382)            |
| Cash distribution to minority interest  |                |                                   |                           | (540)              | (540)               |
| Purchase of units for restricted grants | (908)          |                                   |                           |                    | (908)               |
| Other                                   |                | (16)                              |                           |                    | (16)                |
|   | (24,290)       | (16)                              | (1,800)                   | 1,260              | (24,846)            |
| Cash and cash equivalents               |                |                                   |                           |                    |                     |
| Increase (decrease) for the period      |                | (2,720)                           | 2,728                     |                    | 8                   |
| Beginning of period                     | 2              | 9,819                             | 1,734                     |                    | 11,555              |
| End of period                           | \$ 2           | \$ 7,099                          | \$ 4,462                  | \$                 | \$ 11,563           |

**Condensed Consolidating Statement of Cash Flows**

| <b>Six months ended June 30, 2006</b>   | <b>Parent</b>  | <b>Guarantor<br/>Subsidiaries</b> | <b>Non-<br/>Guarantor</b> | <b>Elimination</b> | <b>Consolidated</b> |
|---|----------------|-----------------------------------|---------------------------|--------------------|---------------------|
|   | (in thousands) |                                   |                           |                    |                     |
| Cash flows from operating activities    | \$ 21,756      | \$ 670                            | \$ 2,860                  | \$ (2,800)         | \$ 22,486           |
| Cash flows from investing activities    |                |                                   |                           |                    |                     |
| additions to properties and equipment   |                | (3,543)                           | (156)                     |                    | (3,699)             |
| Cash flows from financing activities    |                |                                   |                           |                    |                     |
| Distributions to partners               | (21,244)       |                                   | (4,000)                   | 4,000              | (21,244)            |
| Cash distribution to minority interest  |                |                                   |                           | (1,200)            | (1,200)             |
| Purchase of units for restricted grants | (512)          |                                   |                           |                    | (512)               |
|   | (21,756)       |                                   | (4,000)                   | 2,800              | (22,956)            |

|                           |      |           |          |           |
|---------------------------|------|-----------|----------|-----------|
| Cash and cash equivalents |      |           |          |           |
| Decrease for the period   |      | (2,873)   | (1,296)  | (4,169)   |
| Beginning of period       | 2    | 17,770    | 2,811    | 20,583    |
| End of period             | \$ 2 | \$ 14,897 | \$ 1,515 | \$ 16,414 |

**Note 10: Proposed Joint Ventures**

In February 2007, the HLS board of directors authorized a letter of intent with Plains All American Pipeline, L.P. ( Plains ) for HEP to acquire a 25% joint venture interest in a new 95-mile intrastate pipeline system, now being constructed by Plains, for the shipment of up to 120,000 bpd of crude oil into the Salt Lake City area. The pipeline would be owned by a new joint venture company which would be owned 75% by Plains and 25% by HEP. Subject to the actual construction cost, HEP would purchase its interest for between \$22.0 and \$25.5 million in the first quarter of 2008, when the new pipeline system is expected to become fully operational.

As previously announced, Holly has entered into a Memorandum of Understanding with Sinclair Transportation Company ( Sinclair ) to jointly build a 12-inch pipeline from Salt Lake City, Utah to Las Vegas, Nevada, together with terminal facilities in the Cedar City, Utah and north Las Vegas areas (the UNEV Pipeline ).

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Subject to the execution of definitive agreements, Holly will own a 75% interest and Sinclair will own a 25% interest in the project. We have an understanding with Holly that we will be the operator and will have an option to purchase Holly's interest in the project, effective for a 180-day period commencing when the UNEV Pipeline becomes operational, at a purchase price equal to Holly's share of actual costs, plus interest at 7% per annum. The initial capacity of the pipeline will be approximately 62,000 bpd, with the capacity for further expansion to approximately 120,000 bpd. The cost of the pipeline is expected to be approximately \$235.0 million, and the total cost of the project including terminals is expected to be approximately \$300.0 million. Certain preliminary work has already been carried out on this project by Holly. Construction of this project is currently expected to be completed by the end of 2008.

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**HOLLY ENERGY PARTNERS, L.P.**

**Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations**

This Item 2, including but not limited to the sections on Results of Operations and Liquidity and Capital Resources, contains forward-looking statements. See Forward-Looking Statements at the beginning of Part I.

**OVERVIEW**

Holly Energy Partners, L.P. (HEP) is a Delaware limited partnership. We own and operate substantially all of the refined product pipeline and terminalling assets that support the Holly Corporation (Holly) refining and marketing operations in west Texas, New Mexico, Utah, Idaho and Arizona and a 70% interest in Rio Grande Pipeline Company (Rio Grande). HEP is currently 45% owned by Holly.

We operate a system of petroleum product pipelines in Texas, New Mexico and Oklahoma, and distribution terminals in Texas, New Mexico, Arizona, Utah, Idaho, and Washington. We generate revenues by charging tariffs for transporting petroleum products through our pipelines and by charging fees for terminalling refined products and other hydrocarbons, and storing and providing other services at our terminals. We do not take ownership of products that we transport or terminal; therefore, we are not directly exposed to changes in commodity prices.

Our revenues for the six months ended June 30, 2007 were \$51.0 million and our net income for the six months ended June 30, 2007 was \$18.4 million. Our revenues and net income for the six months ended June 30, 2006 were \$41.0 million and \$10.1 million, respectively. Our total operating costs and expenses for the six months ended June 30, 2007 were \$25.9 million, as compared to \$24.6 million for the six months ended June 30, 2006.

***Agreements with Holly Corporation***

We serve Holly's refineries in New Mexico and Utah under two 15-year pipeline and terminal agreements. One of these agreements relates to the pipelines and terminals contributed by Holly to us at the time of our initial public offering and expires in 2019 (Holly PTA). Our other agreement with Holly relates to the Intermediate Pipelines acquired from Holly in July 2005 and expires in 2020 (Holly IPA). The substantial majority of our business is devoted to providing transportation and terminalling services to Holly. Following the July 1, 2007 rate adjustment for the increased producer price index (PPI), the volume commitments by Holly under the Holly PTA will produce at least \$39.6 million of revenue for the twelve months ending June 30, 2008. Under the Holly IPA, Holly agreed to transport volumes of intermediate products on the intermediate pipelines that following the July 1, 2007 PPI adjustment will result in minimum funds to us of \$12.8 million for the twelve months ended June 30, 2008. If Holly fails to meet its minimum revenue commitments 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. A shortfall payment may be applied as a credit in the following four quarters after Holly's minimum obligations are met.

Under certain provisions of an omnibus agreement that we entered with Holly in July 2004 and expires in 2019 (the Omnibus Agreement), we pay Holly an annual administrative fee, initially \$2.0 million for each of the three years following the closing of our initial public offering, for the provision by Holly or its affiliates of various general and administrative services to us. Effective July 1, 2007, the annual fee increased to \$2.3 million in accordance with provisions under the agreement. This fee does not include the salaries of pipeline and terminal personnel or the cost of their employee benefits, such as 401(k), pension and health insurance benefits, which are separately charged to us by Holly. We also reimburse Holly and its affiliates for direct expenses they incur on our behalf.

**Table of Contents****RESULTS OF OPERATIONS (Unaudited)*****Income, Distributable Cash Flow and Volumes***

The following tables present income, distributable cash flow and volume information for the three and six months ended June 30, 2007 and 2006.

|   | <b>Three Months Ended</b>            |             | <b>Six Months Ended</b> |             |
|---|--------------------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>                      |             | <b>June 30,</b>         |             |
|   | <b>2007</b>                          | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
|   | (In thousands, except per unit data) |             |                         |             |
| <b>Revenues</b>   |                                      |             |                         |             |
| Pipelines:  |                                      |             |                         |             |
| Affiliates refined product pipelines  | \$ 9,438                             | \$ 6,374    | \$ 17,677               | \$ 13,697   |
| Affiliates intermediate pipelines   | 4,054                                | 1,841       | 7,063                   | 4,314       |
| Third parties   | 9,355                                | 6,821       | 18,145                  | 15,598      |
|   | 22,847                               | 15,036      | 42,885                  | 33,609      |
| Terminals and truck loading racks:  |                                      |             |                         |             |
| Affiliates  | 2,861                                | 2,369       | 5,403                   | 5,055       |
| Third parties   | 1,423                                | 1,122       | 2,715                   | 2,301       |
|   | 4,284                                | 3,491       | 8,118                   | 7,356       |
| Total revenues  | 27,131                               | 18,527      | 51,003                  | 40,965      |
| <b>Operating costs and expenses</b>   |                                      |             |                         |             |
| Operations  | 8,263                                | 7,429       | 16,040                  | 14,538      |
| Depreciation and amortization   | 3,208                                | 3,781       | 7,279                   | 7,574       |
| General and administrative  | 1,275                                | 1,289       | 2,562                   | 2,513       |
|   | 12,746                               | 12,499      | 25,881                  | 24,625      |
| <b>Operating income</b>   | 14,385                               | 6,028       | 25,122                  | 16,340      |
| Interest income   | 145                                  | 245         | 330                     | 488         |
| Interest expense, including amortization  | (3,371)                              | (3,247)     | (6,729)                 | (6,422)     |
| Gain on sale of assets  | 1                                    |             | 298                     |             |
| Minority interest in Rio Grande   | (154)                                | (28)        | (581)                   | (273)       |
| <b>Net income</b>   | 11,006                               | 2,998       | 18,440                  | 10,133      |
| Less general partner interest in net income, including incentive distributions <sup>(1)</sup> | 726                                  | 319         | 1,306                   | 646         |
| <b>Limited partners interest in net income</b>  | \$ 10,280                            | \$ 2,679    | \$ 17,134               | \$ 9,487    |

|   |           |           |           |           |
|---|-----------|-----------|-----------|-----------|
| <b>Net income per limited partner unit - basic and diluted</b> <sup>(1)</sup> | \$ 0.64   | \$ 0.17   | \$ 1.06   | \$ 0.59   |
| <b>Weighted average limited partners units outstanding</b>                    | 16,108    | 16,108    | 16,108    | 16,108    |
| <b>EBITDA</b> <sup>(2)</sup>  | \$ 17,440 | \$ 9,781  | \$ 32,118 | \$ 23,641 |
| <b>Distributable cash flow</b> <sup>(3)</sup>                                 | \$ 12,389 | \$ 10,293 | \$ 24,983 | \$ 21,507 |
| <b>Volumes (bpd)</b>  |           |           |           |           |
| Pipelines:  |           |           |           |           |
| Affiliates refined product pipelines  | 82,571    | 55,793    | 77,494    | 61,151    |
| Affiliates intermediate pipelines   | 68,437    | 44,955    | 63,980    | 52,959    |
| Third parties   | 64,487    | 52,134    | 64,835    | 64,666    |
|   | 215,495   | 152,882   | 206,309   | 178,776   |
| Terminals and truck loading racks:  |           |           |           |           |
| Affiliates  | 123,245   | 107,302   | 121,724   | 113,202   |
| Third parties   | 53,179    | 41,266    | 50,030    | 44,145    |
|   | 176,424   | 148,568   | 171,754   | 157,347   |
| <b>Total for pipelines and terminal assets (bpd)</b>                          | 391,919   | 301,450   | 378,063   | 336,123   |

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- (1) Net income is allocated between limited partners and the general partner interest in accordance with the provisions of the partnership agreement. Net income allocated to the general partner includes any incentive distributions declared in the period. Incentive distributions of \$0.5 million and \$0.3 million were declared during the three months ended June 30, 2007 and 2006, respectively, and \$1.0 million and \$0.5 million during the six months ended June 30, 2007 and 2006, respectively. The net income applicable to the limited partners is divided by the weighted average limited partner units outstanding in computing the net income per unit applicable to limited partners.

- (2) Earnings before interest, taxes, depreciation and amortization ( EBITDA ) is calculated as net income plus
- (i) interest expense net of interest income and
  - (ii) depreciation and amortization.
- EBITDA is not a calculation based upon U.S. generally accepted accounting principles ( U.S. GAAP ). However, the amounts included in the EBITDA calculation are derived from amounts included in our consolidated financial statements. EBITDA should not be considered as an alternative to net income or operating income, as an indication of our operating performance or as an alternative to operating cash flow as a measure of liquidity. EBITDA is not necessarily



comparable to similarly titled measures of other companies. EBITDA is presented here because it is a widely used financial indicator used by investors and analysts to measure performance. EBITDA is also used by our management for internal analysis and as a basis for compliance with financial covenants.

Set forth below is our calculation of EBITDA.

|   | <b>Three Months<br/>Ended<br/>June 30,</b> |                 | <b>Six Months Ended<br/>June 30,</b> |                  |
|---|--|-----------------|--------------------------------------|------------------|
|   | <b>2007</b>                                | <b>2006</b>     | <b>2007</b>                          | <b>2006</b>      |
|   | (In thousands)                             |                 |                                      |                  |
| <b>Net income</b>   | \$ 11,006                                  | \$ 2,998        | \$ 18,440                            | \$ 10,133        |
| Add interest expense  | 3,067                                      | 3,005           | 6,122                                | 5,938            |
| Add amortization of discount and deferred debt issuance costs | 304  | 242             | 607                                  | 484              |
| Subtract interest income                                      | (145)                                      | (245)           | (330)                                | (488)            |
| Add depreciation and amortization                             | 3,208                                      | 3,781           | 7,279                                | 7,574            |
| <b>EBITDA</b>   | <b>\$ 17,440</b>                           | <b>\$ 9,781</b> | <b>\$ 32,118</b>                     | <b>\$ 23,641</b> |

(3) Distributable cash flow is not a calculation based upon U.S. GAAP.

However, the amounts included in the calculation are derived from amounts separately presented in our consolidated financial statements, with the exception of maintenance capital expenditures. Distributable cash flow should not be considered in isolation or as an alternative to net income or operating income, as an indication of our operating performance or as an alternative to operating cash flow as a measure of liquidity. Distributable cash flow is not necessarily comparable to similarly titled measures of other companies. Distributable cash flow is presented here because it is a widely accepted financial indicator used by investors to compare partnership performance.

We believe that this measure provides investors an enhanced perspective of the operating performance of our assets and the cash our business is generating.

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Set forth below  
is our  
calculation of  
distributable  
cash flow.

|   | <b>Three Months Ended</b> |             | <b>Six Months Ended</b> |             |
|---|---------------------------|-------------|-------------------------|-------------|
|   | <b>June 30,</b>           |             | <b>June 30,</b>         |             |
|   | <b>2007</b>               | <b>2006</b> | <b>2007</b>             | <b>2006</b> |
|   | (In thousands)            |             |                         |             |
| <b>Net income</b>   | \$ 11,006                 | \$ 2,998    | \$ 18,440               | \$ 10,133   |
| Add depreciation and amortization                             | 3,208                     | 3,781       | 7,279                   | 7,574       |
| Add amortization of discount and deferred debt issuance costs | 304                       | 242         | 607                     | 484         |
| Add (subtract) increase (decrease) in deferred revenue        | (1,896)                   | 3,432       | (990)                   | 3,916       |
| Subtract maintenance capital expenditures*                    | (233)                     | (160)       | (353)                   | (600)       |
| <b>Distributable cash flow</b>                                | \$ 12,389                 | \$ 10,293   | \$ 24,983               | \$ 21,507   |

\* Maintenance capital expenditures are capital expenditures made to replace partially or fully depreciated assets in order to maintain the existing operating capacity of our assets and to extend their useful lives.

|                           | <b>June 30,</b> | <b>December 31,</b> |
|---------------------------|-----------------|---------------------|
|                           | <b>2007</b>     | <b>2006</b>         |
|                           | (In thousands)  |                     |
| <b>Balance Sheet Data</b> |                 |                     |
| Cash and cash equivalents | \$ 11,563       | \$ 11,555           |
| Working capital           | \$ 10,333       | \$ 9,450            |
| Total assets              | \$ 235,189      | \$ 243,573          |
| Long-term debt            | \$ 181,443      | \$ 180,660          |
| Partners equity           | \$ 31,139       | \$ 36,226           |

As a master limited partnership, we distribute our available cash, which exceeds our net income because depreciation and amortization expense represents a non-cash charge against income. The result is a decline in partners' equity since our regular quarterly distributions exceed our quarterly net income.

**Results of Operations Three Months Ended June 30, 2007 Compared with Three Months Ended June 30, 2006**  
**Summary**

Net income increased by \$8.0 million from \$3.0 million for the three months ended June 30, 2006 to \$11.0 million for the three months ended June 30, 2007. The increase in overall earnings was principally due to an increase in volumes transported on our pipeline systems, the effects of annual tariff increases on our pipelines and the recognition of certain previously deferred revenue, offset by an increase in our operating costs and expenses. Approximately \$0.7 million of revenue relating to deficiency payments associated with certain guaranteed shipping contracts was deferred during the three months ended June 30, 2007. Such revenue will be recognized in future periods either as payment for shipments in excess of guaranteed levels or when shipping rights expire unused after a twelve-month period.

**Revenues**

Revenues increased by \$8.6 million from \$18.5 million for the three months ended June 30, 2006 to \$27.1 million for the three months ended June 30, 2007. The increase in revenue was principally due to an increase in volumes transported on our pipeline systems, the effects of annual tariff increases on our pipelines and the realization of \$2.6 million of certain previously deferred revenue.

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The large increase in revenues and net income for the three months ended June 30, 2007 as compared to the same period in 2006 is principally due to significant downtime at all of the refineries served by our product distribution network in the second quarter of 2006. These refineries, including Holly's Navajo and Woods Cross refineries and Alon's Big Spring refinery, were required to produce ultra low sulfur diesel fuel ( ULSD ) by June 2006. To meet this requirement, downtime at the refineries was required so that ULSD-associated projects could be brought on line. Additionally, in the second quarter of 2006, Holly completed an expansion of the Navajo refinery. The tie-in of these new projects coming on line, combined with other refinery maintenance, much of which was timed in conjunction with the capital projects, resulted in reduced refinery production, which was the principal factor contributing to a significant volume decrease during the second quarter of 2006. Since the expansion of Holly's Navajo refinery in mid-year 2006, increased production has contributed to increased volume shipments on our pipeline systems.

Revenues from the refined product pipelines increased by \$5.6 million from \$13.2 million for the three months ended June 30, 2006 to \$18.8 million for the three months ended June 30, 2007. This increase in refined product pipeline revenue is principally due to an increase in the volumes shipped on our refined product pipeline systems, the effect of the annual tariff increase on refined product shipments and the realization of \$1.5 million of previously deferred revenue as the contractual period had expired to provide certain pipeline services that had previously been paid for. Shipments on our refined product pipelines increased to an average of 147.1 thousand barrels per day ( mbpd ) for the three months ended June 30, 2007 as compared to 107.9 mbpd for the three months ended June 30, 2006.

Revenues from the intermediate product pipelines increased by \$2.2 million from \$1.8 million for the three months ended June 30, 2006 to \$4.0 million for the three months ended June 30, 2007. This increase in intermediate pipeline revenue is principally due to an increase in volumes shipped on our intermediate pipelines, the effect of the annual increase in the intermediate pipeline tariff and the realization of \$1.1 million of previously deferred revenue as the contractual period had expired to provide certain pipeline services that had previously been paid for. Shipments on our intermediate product pipelines increased to an average of 68.4 mbpd for the three months ended June 30, 2007 as compared to 45.0 mbpd for the three months ended June 30, 2006.

Revenues from terminal and truck loading rack service fees increased by \$0.8 million from \$3.5 million for the three months ended June 30, 2006 to \$4.3 million for the three months ended June 30, 2007. Refined products terminalled in our facilities increased to an average of 176.4 mbpd for the three months ended June 30, 2007 as compared to 148.6 mbpd for the three months ended June 30, 2006.

***Operating Costs***

Operations expense increased by \$0.8 million from the three months ended June 30, 2006 to the three months ended June 30, 2007. This increase in expense was principally due to an increase in pipeline and terminal maintenance expense and an increase in the cost of employees who perform services for us, including the addition of two new senior level executives.

***Depreciation and Amortization***

Depreciation and amortization decreased by \$0.6 million from the three months ended June 30, 2006 to the three months ended June 30, 2007, principally due to a reduction in amortization expense as a transportation agreement became fully amortized in April 2007.

***General and Administrative***

General and administrative costs of \$1.3 million for the three months ended June 30, 2007 were relatively flat as compared to the three months ended June 30, 2006.

***Interest Expense***

Interest expense for the three months ended June 30, 2007 totaled \$3.4 million, an increase of \$0.2 million from \$3.2 million for the three months ended June 30, 2006. For the three months ended June 30,

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2007, interest expense consisted of: \$3.0 million of interest on our outstanding debt, net of the impact of the interest rate swap; \$0.1 million of commitment fees on the unused portion of the credit facility; and \$0.3 million of amortization of the discount on the senior notes and deferred debt issuance costs. For the three months ended June 30, 2006, interest expense consisted of: \$2.9 million of interest on our outstanding debt, net of the impact of the interest rate swap; \$0.1 million of commitment fees on the unused portion of the credit facility; and \$0.2 million of amortization of the discount on the senior notes and deferred debt issuance costs.

***Minority Interest in Earnings of Rio Grande***

The minority interest related to the 30% of Rio Grande that we do not own reduced our income by \$0.2 million for the three months ended June 30, 2007 as compared to \$28,000 for the three months ended June 30, 2006.

**Results of Operations Six Months Ended June 30, 2007 Compared with Six Months Ended June 30, 2006*****Summary***

Net income increased by \$8.3 million from \$10.1 million for the six months ended June 30, 2006 to \$18.4 million for the six months ended June 30, 2007. The increase in overall earnings was principally due to an increase in volumes transported on our pipeline systems, the effects of annual tariff increases on our pipelines and the recognition of certain previously deferred revenue, offset by an increase in our operating costs and expenses. Approximately \$2.1 million of revenue relating to deficiency payments associated with certain guaranteed shipping contracts was deferred during the six months ended June 30, 2007. Such revenue will be recognized in future periods either as payment for shipments in excess of guaranteed levels or when shipping rights expire unused after a twelve-month period.

***Revenues***

Revenues increased by \$10.0 million from \$41.0 million for the six months ended June 30, 2006 to \$51.0 million for the six months ended June 30, 2007. This increase resulted principally from an increase in volumes transported on our pipeline systems, the effect of annual tariff increases on our pipelines systems and the realization of \$3.1 million of certain previously deferred revenue.

The large increase in revenues and net income for the six months ended June 30, 2007 as compared to the same period in 2006 is principally due to significant downtime at all of the refineries served by our product distribution network in the second quarter of 2006. These refineries, including Holly's Navajo and Woods Cross refineries and Alon's Big Spring refinery, were required to produce ULSD fuel by June 2006. To meet this requirement, downtime at the refineries was required so that ULSD-associated projects could be brought on line. Additionally, Holly completed an expansion of the Navajo refinery. The tie-in of these new projects coming on line, combined with other refinery maintenance, much of which was timed in conjunction with the capital projects, resulted in reduced refinery production, which was the principal factor contributing to a significant volume decrease during the second quarter of 2006. Since the expansion of Holly's Navajo refinery in mid-year 2006, increased production has contributed to increased volume shipments on our pipeline systems.

Revenues from the refined product pipelines increased by \$6.5 million from \$29.3 million for the six months ended June 30, 2006 to \$35.8 million for the six months ended June 30, 2007. This increase in refined product pipeline revenue is principally due to an increase in volumes shipped on our refined product pipelines, the effect of the annual tariff increase on refined product shipments, and the realization of \$1.5 million of previously deferred revenue as the contractual period had expired to provide certain pipeline services that had previously been paid for. Shipments on our refined product pipelines increased to an average of 142.3 mbpd for the six months ended June 30, 2007 as compared to 125.8 mbpd for the six months ended June 30, 2006.

Revenues from the intermediate product pipelines increased by \$2.8 million from \$4.3 million for the six months ended June 30, 2006 to \$7.1 million for the six months ended June 30, 2007. This increase in

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intermediate pipeline revenue is principally due to an increase in volumes shipped on our intermediate pipelines, the effect of the annual increase in the intermediate pipeline tariff and the realization of \$1.6 million of previously deferred revenue as the contractual period had expired to provide certain pipeline services that had previously been paid for. Shipments on our intermediate product pipelines increased to an average of 64.0 mbpd for the six months ended June 30, 2007 as compared to 53.0 mbpd for the six months ended June 30, 2006.

Revenues from terminal and truck loading rack service fees increased by \$0.7 million from \$7.4 million for the six months ended June 30, 2006 to \$8.1 million for the six months ended June 30, 2007. Refined products terminalled in our facilities increased to an average of 171.8 mbpd for the six months ended June 30, 2007 as compared to 157.3 mbpd for the six months ended June 30, 2006.

***Operating Costs***

Operations expense increased by \$1.5 million from the six months ended June 30, 2006 to the six months ended June 30, 2007. This increase in expense was principally due to an increase in pipeline and terminal maintenance expense and an increase in the cost of employees who perform services for us, including the addition of two new senior level executives.

***Depreciation and Amortization***

Depreciation and amortization decreased by \$0.3 million from the six months ended June 30, 2006 to the six months ended June 30, 2007, due principally to a reduction in amortization expense, as a transportation agreement became fully amortized in April 2007, partially offset by depreciation and amortization on fixed asset additions.

***General and Administrative***

General and administrative costs increased by less than \$0.1 million from the six months ended June 30, 2006 to the six months ended June 30, 2007.

***Interest Expense***

Interest expense for the six months ended June 30, 2007 totaled \$6.7 million, an increase of \$0.3 million from \$6.4 million for the six months ended June 30, 2006. For the six months ended June 30, 2007, interest expense consisted of: \$5.9 million of interest on our outstanding debt, net of the impact of the interest rate swap; \$0.2 million of commitment fees on the unused portion of the credit facility; and \$0.6 million of amortization of the discount on the senior notes and deferred debt issuance costs. For the six months ended June 30, 2006, interest expense consisted of: \$5.7 million of interest on our outstanding debt, net of the impact of the interest rate swap; \$0.2 million of commitment fees on the unused portion of the credit facility; and \$0.5 million of amortization of the discount on the senior notes and deferred debt issuance costs.

***Minority Interest in Earnings of Rio Grande***

The minority interest related to the 30% of Rio Grande that we do not own reduced our income by \$0.6 million for the six months ended June 30, 2007 as compared to \$0.3 million for the six months ended June 30, 2006.

**LIQUIDITY AND CAPITAL RESOURCES**

***Overview***

We have a four-year, \$100.0 million senior secured revolving credit agreement (the Credit Agreement ) expiring in July 2008. The Credit Agreement is available to fund capital expenditures, acquisitions, and working capital and for general partnership purposes. As of June 30, 2007, we had no amounts outstanding under the Credit Agreement.



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Our senior notes maturing March 1, 2015 are registered with the SEC and bear interest at 6.25% ( Senior Notes ). The Senior Notes are unsecured and impose certain restrictive covenants, 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.

Under our shelf registration statement, filed September 2, 2005, we may offer from time to time up to \$800.0 million of our securities, through one or more prospectus supplements that would describe, among other things, the specific amounts, prices and terms of any securities offered and how the proceeds would be used. Any proceeds from the sale of securities would be used for general business purposes, which may include, among other things, funding acquisitions of assets or businesses, working capital, capital expenditures, investments in subsidiaries, the retirement of existing debt and/or the repurchase of common units or other securities.

We believe our current cash balances, future internally-generated funds and funds available under our Credit Agreement will provide sufficient resources to meet our working capital liquidity needs for the foreseeable future. In May 2007, we paid a regular cash distribution for the first quarter of 2007 of \$0.69 on all units, an aggregate amount of \$11.9 million. Included in this distribution was \$0.5 million paid to the general partner as an incentive distribution, as the distribution per unit exceeded \$0.55.

Cash and cash equivalents increased by less than \$0.1 million during the six months ended June 30, 2007. The cash flows generated from operating activities of \$26.5 million were offset by cash flows used for financing activities of \$24.8 million, in addition to cash flows used for investing activities of \$1.6 million. Working capital increased by \$0.9 million to \$10.3 million during the six months ended June 30, 2007.

***Cash Flows - Operating Activities***

Cash flows from operating activities increased by \$4.0 million from \$22.5 million for the six months ended June 30, 2006 to \$26.5 million for the six months ended June 30, 2007. This increase is mainly due to \$5.1 million in additional cash collections from our major customers, resulting principally from increased revenues and shortfall billings, partially offset by miscellaneous year-over-year changes in collections and payments.

As discussed above, our major shippers are obligated to make deficiency payments to us if we do not receive certain minimum revenue payments. Certain of these shippers then have the right to recapture these amounts if future revenues exceed minimum levels. During the first six months of 2007, we received cash payments of approximately \$2.7 million under these commitments. We billed \$3.1 million in the first six months of 2006 related to shortfalls produced during the six months ended June 30, 2006, which expired without recapture and was recognized as revenue in the first six months of 2007. Another \$0.7 million is included in our accounts receivable at June 30, 2007 related to shortfalls produced in the second quarter of 2007.

***Cash Flows - Investing Activities***

Cash flows used for investing activities decreased by \$2.1 million from \$3.7 million for the six months ended June 30, 2006 to \$1.6 million for the six months ended June 30, 2007. Additions to properties and equipment for the six months ended June 30, 2007 were \$1.9 million, a decrease of \$1.8 million from \$3.7 million for the six months ended June 30, 2006. During the six months ended June 30, 2007, we also received cash proceeds of \$0.3 million on the sale of certain assets.

***Cash Flows - Financing Activities***

Cash flows used for financing activities were \$24.8 million for the six months ended June 30, 2007 as compared to \$23.0 million for the six months ended June 30, 2006. During the first six months of 2007, we paid cash distributions on all units and the general partner interest in the aggregate amount of \$23.4

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million, an increase of \$2.2 million from \$21.2 million in distributions paid during the first six months of 2006. Cash distributions paid to the minority interest owner in Rio Grande was \$0.5 million for the six months ended June 30, 2007, as compared to \$1.2 million for the six months ended June 30, 2006.

***Capital Requirements***

Our pipeline and terminalling operations are capital intensive, requiring investments to maintain, expand, upgrade or enhance existing operations and to meet environmental and operational regulations. Our capital requirements have consisted of, and are expected to continue to consist of, maintenance capital expenditures and expansion capital expenditures. Maintenance capital expenditures represent capital expenditures to replace partially or fully depreciated assets to maintain the operating capacity of existing assets. Maintenance capital expenditures include expenditures required to maintain equipment reliability, tankage and pipeline integrity, and safety and to address environmental regulations. Expansion capital expenditures represent capital expenditures to expand the operating capacity of existing or new assets, whether through construction or acquisition. Expansion capital expenditures include expenditures to acquire assets to grow our business and to expand existing facilities, such as projects that increase throughput capacity on our pipelines and in our terminals. Repair and maintenance expenses associated with existing assets that are minor in nature and do not extend the useful life of existing assets are charged to operating expenses as incurred.

Each year the Holly Logistic Services, L.L.C. ( HLS ) board of directors approves our annual capital budget, which specifies capital projects that our management is authorized to undertake. Additionally, at times when conditions warrant or as new opportunities arise, special projects may be approved. The funds allocated for a particular capital project may be expended over a period of years, depending on the time required to complete the project. Therefore, our planned capital expenditures for a given year consist of expenditures approved for capital projects included in the current year s capital budget as well as, in certain cases, expenditures approved for capital projects in capital budgets for prior years.

In February 2007, the HLS board of directors authorized a letter of intent with Plains All American Pipeline, L.P. ( Plains ) for HEP to acquire a 25% joint venture interest in a new 95-mile intrastate pipeline system, now being constructed by Plains, for the shipment of up to 120,000 bpd of crude oil into the Salt Lake City area. The pipeline would be owned by a new joint venture company which would be owned 75% by Plains and 25% by HEP. Subject to the actual construction cost, HEP would purchase its interest for between \$22.0 and \$25.5 million in the first quarter of 2008, when the new pipeline system is expected to become fully operational. The pipeline will allow various refiners in the Salt Lake City area, including Holly s Woods Cross refinery, to ship crude oil into the Salt Lake City area from the Utah terminus of the Frontier Pipeline as well as crude oil from Wyoming and Utah, which is currently flowing on Plains Rocky Mountain Pipeline. Our investment in the project is subject to various conditions, including the negotiation and execution of mutually satisfactory definitive agreements.

We anticipate that our currently planned expenditures for sustaining and maintenance capital as well as expenditures for smaller capital development projects (including the investment in the Utah crude oil pipeline project as described in the preceding paragraph) will be funded with existing cash balances, cash generated by operations and advances under our Credit Agreement.

As previously announced, Holly has entered into a Memorandum of Understanding with Sinclair Transportation Company ( Sinclair ) to jointly build a 12-inch pipeline from Salt Lake City, Utah to Las Vegas, Nevada, together with terminal facilities in the Cedar City, Utah and north Las Vegas areas (the UNEV Pipeline ). Subject to the execution of definitive agreements, Holly will own a 75% interest and Sinclair will own a 25% interest in the project. We have an understanding with Holly that we will be the operator and will have an option to purchase Holly s interest in the project, effective for a 180-day period commencing when the UNEV Pipeline becomes operational, at a purchase price equal to Holly s share of actual costs, plus interest at 7% per annum. The initial capacity of the pipeline will be approximately 62,000 bpd, with the capacity for further expansion to approximately 120,000 bpd. The cost of the pipeline is expected to be approximately \$235.0 million, and the total cost of the project including terminals is expected to be approximately \$300.0 million. Certain preliminary work has already been carried out on this project by Holly. Construction of this project is currently expected to be completed by the end of 2008.

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The HLS Board of Directors has also approved a \$48.3 million project to expand portions of the Artesia, New Mexico to El Paso, Texas refined products pipeline and terminal system. The project includes the replacement of 85 miles of existing 8-inch pipeline with 12-inch pipeline, additional tankage capacity and other enhancements to tie into the Kinder Morgan pump station in El Paso, enabling us to transport increased volumes following the completion of Holly's planned expansion of the Navajo refinery. The expansion will also allow us to transport up to 10,000 bpd of refinery feedstocks to third parties in El Paso, Texas. The project is subject to entry into an agreement with Holly for an increase in our tariffs for pipeline shipments from the Navajo refinery.

We are also studying several other projects, which are in various stages of analysis.

We expect to use the issuance of common units and/or debt securities as well as borrowing under our Credit Agreement as the principal means of financing large investments in major capital projects such as the proposed Salt Lake City to Las Vegas pipeline project described in the preceding paragraph.

***Credit Agreement***

We have a four-year, \$100.0 million senior secured revolving Credit Agreement expiring in July 2008. Union Bank of California, N.A. is a lender and serves as administrative agent under this agreement. The Credit Agreement is available to fund capital expenditures, acquisitions, and working capital and for general partnership purposes. Advances under the Credit Agreement that are designated for working capital are short-term liabilities. Other advances under the Credit Agreement are classified as long-term liabilities. In addition, the Credit Agreement is available to fund letters of credit up to a \$50.0 million sub-limit. Up to \$5.0 million is available to fund distributions to unitholders. As of June 30, 2007, we had no amounts outstanding under the Credit Agreement.

We have the right to request an increase in the maximum amount of the Credit Agreement, up to \$175.0 million. Such request will become effective if (a) certain conditions specified in the Credit Agreement are met and (b) existing lenders under the Credit Agreement or other financial institutions reasonably acceptable to the administrative agent commit to lend such increased amounts under the agreement.

Our obligations under the Credit Agreement are secured by substantially all of our assets. Indebtedness under the Credit Agreement is recourse to our general partner and guaranteed by our wholly-owned subsidiaries.

We may prepay all loans at any time without penalty. We are required to reduce all working capital borrowings under the Credit Agreement to zero for a period of at least 15 consecutive days once each twelve-month period prior to the maturity date of the agreement.

Indebtedness under the Credit Agreement bears interest, at our option, at either (a) the base rate as announced by the administrative agent plus an applicable margin (ranging from 0.25% to 1.00%) or (b) at a rate equal to the London Interbank Offered Rate ( LIBOR ) plus an applicable margin (ranging from 1.50% to 2.25%). In each case, the applicable margin is based upon the ratio of our funded debt (as defined in the agreement) to EBITDA (earnings before interest, taxes, depreciation and amortization, as defined in the Credit Agreement). We incur a commitment fee on the unused portion of the Credit Agreement at a rate of 0.375% or 0.500% based upon the ratio of our funded debt to EBITDA for the four most recently completed fiscal quarters. The agreement matures in July 2008. At that time, the agreement will terminate and all outstanding amounts thereunder will be due and payable.

The Credit Agreement imposes certain requirements, 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 EBITDA to interest expense ratio and debt to EBITDA ratio. If an event of default exists under the agreement, the lenders will be able to accelerate the maturity of the debt and exercise other rights and remedies.

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***Senior Notes Due 2015***

The Senior Notes mature on March 1, 2015 and bear interest at 6.25%. The Senior Notes are unsecured and impose certain restrictive covenants, 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.

The \$185.0 million principal amount of Senior Notes is recorded at \$181.4 million on our accompanying consolidated balance sheet at June 30, 2007. The difference is due to the \$2.9 million unamortized discount and \$0.7 million relating to the fair value of the interest rate swap contract as further discussed under Risk Management.

***Impact of Inflation***

Inflation in the United States has been relatively low in recent years and did not have a material impact on our results of operations for the six months ended June 30, 2007 and 2006.

A substantial majority of our revenues are generated under long-term contracts that include the right to increase our rates and minimum revenue guarantees annually for increases in the PPI. Historically, the PPI has increased an average of 3.9% annually over the past 3 calendar years.

***Environmental Matters***

Our operation of pipelines, terminals, and associated facilities in connection with the storage and transportation of refined products is subject to stringent and complex federal, state, and local laws and regulations governing the discharge of materials into the environment, or otherwise relating to the protection of the environment. As with the industry generally, compliance with existing and anticipated laws and regulations increases our overall cost of business, including our capital costs to construct, maintain, and upgrade equipment and facilities. While these laws and regulations affect our maintenance capital expenditures and net income, we believe that they do not affect our competitive position in that the operations of our competitors are similarly affected. We believe that our operations are in substantial compliance with applicable environmental laws and regulations. However, these laws and regulations, and the interpretation or enforcement thereof, are subject to frequent change by regulatory authorities, and we are unable to predict the ongoing cost to us of complying with these laws and regulations or the future impact of these laws and regulations on our operations. Violation of environmental laws, regulations, and permits can result in the imposition of significant administrative, civil and criminal penalties, injunctions, and construction bans or delays. A discharge of hydrocarbons or hazardous substances into the environment could, to the extent the event is not insured, subject us to substantial expense, including both the cost to comply with applicable laws and regulations and claims made by employees, neighboring landowners and other third parties for personal injury and property damage.

We inspect our pipelines regularly using equipment rented from third-party suppliers. Third parties also assist us in interpreting the results of the inspections.

Holly has agreed to indemnify us in an aggregate amount not to exceed \$15.0 million for ten years after the closing of our initial public offering on July 13, 2004 for environmental noncompliance and remediation liabilities associated with the assets initially transferred to us and occurring or existing before that date, and provide \$2.5 million of additional indemnification for the Intermediate Pipelines acquired in July 2005. Additionally, we entered into an environmental agreement with Alon with respect to pre-closing environmental costs and liabilities relating to the pipelines and terminals acquired from Alon in February 2005, where Alon will indemnify us for ten years subject to a \$100,000 deductible and a \$20.0 million maximum liability cap.

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Contamination resulting from spills of refined products and crude oil is not unusual within the petroleum pipeline industry. Historic spills along our existing pipelines and terminals as a result of past operations have resulted in contamination of the environment, including soils and groundwater. Site conditions, including soils and groundwater, are being evaluated at a few of our properties where operations may have resulted in releases of hydrocarbons and other wastes, none of which we believe will have a significant effect on our operations as they would be covered under an environmental indemnification agreement.

An environmental remediation project is in progress currently at our El Paso terminal, the remaining costs of which are projected to be approximately \$2.1 million over the next five years. Other parties are undertaking remediation projects at our Boise, Burley and Albuquerque terminals, and we are obligated to pay a portion of these costs at the Albuquerque terminal, but not at the Boise or Burley terminals. As of June 30, 2007, we estimate the total remaining remediation cost for the Albuquerque terminal to be insignificant. A remediation project is also under way in New Mexico concerning a leak on our refined product pipeline from Artesia, New Mexico to Orla, Texas. As of June 30, 2007, we estimate the remaining cost on this project to be \$0.3 million, of which \$0.1 million will be incurred in 2007. Holly has agreed, subject to a \$15.0 million limit, to indemnify us for environmental liabilities related to the assets transferred to us by Holly to the extent such liabilities existed or arose from operation of these assets prior to the closing of our initial public offering on July 13, 2004 and are asserted within 10 years after that date. The Holly indemnification will cover the costs associated with the remediation projects mentioned above, including assessment, monitoring, and remediation programs.

In the fourth quarter of 2005, we experienced a refined product release near Sweetwater, Texas. As of June 30, 2007, we estimate that the total remaining remediation cost for this incident to be insignificant. This occurrence is not subject to indemnification from Alon.

We may experience future releases into the environment from our pipelines and terminals, or discover historical releases that were previously unidentified or not assessed. Although we maintain an extensive inspection and audit program designed, as applicable, to prevent, detect and address these releases promptly, damages and liabilities incurred due to any future environmental releases from our assets nevertheless have the potential to substantially affect our business.

**CRITICAL ACCOUNTING POLICIES**

Our discussion and analysis of our financial condition and results of operations are based upon our consolidated financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenues and expenses, and related disclosure of contingent assets and liabilities as of the date of the financial statements. Actual results may differ from these estimates under different assumptions or conditions. We consider the following policies to be the most critical to understanding the judgments that are involved and the uncertainties that could impact our results of operations, financial condition and cash flows.

Our significant accounting policies are described in Item 7. Management's Discussion and Analysis of Financial Condition and Operations Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2006. Certain critical accounting policies that materially affect the amounts recorded in our consolidated financial statements include revenue recognition, assessing the possible impairment of certain long-lived assets and assessing contingent liabilities for probable losses. There have been no changes to these policies in 2007.

**Recent Accounting Pronouncements**

*Interpretation No. 48 Accounting for Uncertainty in Income Taxes*

In June 2006, the Financial Accounting Standards Board ( FASB ) issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes. This interpretation clarifies the accounting for uncertainty in income taxes recognized in an enterprise's financial statements by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. This interpretation also provides guidance on

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derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. We adopted this standard effective January 1, 2007. The adoption of this standard did not have a material impact on our financial condition, results of operations and cash flows.

**RISK MANAGEMENT**

We have entered into an interest rate swap contract to effectively convert the interest expense associated with \$60.0 million of our 6.25% Senior Notes from a fixed rate to variable rates. Under the swap agreement, we receive 6.25% fixed rate on the notional amount and pay a variable rate equal to three-month LIBOR plus an applicable margin of 1.1575%. The variable rate being paid on the notional amount at June 30, 2007 was 6.5175%, including the applicable margin. The maturity of the swap contract is March 1, 2015, matching the maturity of the Senior Notes.

This interest rate swap has been designated as a fair value hedge as defined by SFAS No. 133. Our interest rate swap meets the conditions required to assume no ineffectiveness under SFAS No. 133 and, therefore, we have used the shortcut method of accounting prescribed for fair value hedges by SFAS No. 133. Accordingly, we adjust the carrying value of the swap to its fair value each quarter, with an offsetting entry to adjust the carrying value of the debt securities whose fair value is being hedged. We record interest expense equal to the variable rate payments under the swaps.

The fair value of the interest rate swap agreement of \$0.7 million is included in Other long-term liabilities in our accompanying consolidated balance sheet at June 30, 2007. The offsetting entry to adjust the carrying value of the debt securities whose fair value is being hedged is recognized as a reduction of Long-term debt on our accompanying consolidated balance sheet at June 30, 2007.

The market risk inherent in our debt instruments and positions is the potential change arising from increases or decreases in interest rates as discussed below.

At June 30, 2007, we had an outstanding principal balance on our unsecured Senior Notes of \$185.0 million. By means of our interest rate swap contract, we have effectively converted \$60.0 million of the Senior Notes from a fixed rate to variable rate. For the fixed rate debt portion of \$125.0 million, changes in interest rates would generally affect the fair value of the debt, but not our earnings or cash flows. Conversely, for the variable rate debt portion of \$60.0 million, changes in interest rates would generally not impact the fair value of the debt, but may affect our future earnings and cash flows. We estimate a hypothetical 10% change in the yield-to-maturity applicable to our fixed rate debt portion of \$125.0 million as of June 30, 2007 would result in a change of approximately \$5.0 million in the fair value of the debt. A hypothetical 10% change in the interest rate applicable to our variable rate debt portion of \$60.0 million would not have a material effect on our earnings or cash flows.

At June 30, 2007, our cash and cash equivalents included highly liquid investments with a maturity of three months or less at the time of purchase. Due to the short-term nature of our cash and cash equivalents, a hypothetical 10% increase in interest rates would not have a material effect on the fair market value of our portfolio. Since we have the ability to liquidate this portfolio, we do not expect our operating results or cash flows to be materially affected to any significant degree by the effect of a sudden change in market interest rates on our investment portfolio.

Our operations are subject to normal hazards of operations, including fire, explosion and weather-related perils. We maintain various insurance coverages, including business interruption insurance, subject to certain deductibles. We are not fully insured against certain risks because such risks are not fully insurable, coverage is unavailable, or premium costs, in our judgment, do not justify such expenditures.

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**Item 3. Quantitative and Qualitative Disclosures About Market Risks**

Market risk is the risk of loss arising from adverse changes in market rates and prices. See Risk Management under Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of market risk exposures that we have with respect to our cash and cash equivalents and long-term debt. We utilize derivative instruments to hedge our interest rate exposure, also discussed under Risk Management.

Since we do not own products shipped on our pipelines or terminalled at our terminal facilities we do not have market risks associated with commodity prices.

**Item 4. Controls and Procedures**

**(a) Evaluation of disclosure controls and procedures**

Our principal executive officer and principal financial officer have evaluated, as required by Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act), our disclosure controls and procedures (as defined in Exchange Act Rule 13a-15(e)) as of the end of the period covered by this quarterly report on Form 10-Q. Based on that evaluation, the principal executive officer and principal financial officer concluded that the design and operation of our disclosure controls and procedures are effective in ensuring that information we are required to disclose in the reports that we file or submit under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

**(b) Changes in internal control over financial reporting**

During the quarter ended June 30, 2007, we implemented a new accounting software system, which required modifications to our existing system of internal control over financial reporting due to the technical changes in the accounting software system. We have reviewed our modified internal controls and believe that they are appropriate and are functioning effectively.

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PART II. OTHER INFORMATION

**Item 1. Legal proceedings**

We are a party to various legal and regulatory proceedings, none of which we believe will have a material adverse impact on our financial condition, results of operations or cash flows.

**Item 6. Exhibits**

- 12.1\* Computation of Ratio of Earnings to Fixed Charges
- 31.1\* Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
- 31.2\* Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002.
- 32.1\* Certification of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002.
- 32.2\* Certification of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002.

\* Filed herewith

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HOLLY ENERGY PARTNERS, L.P.

**SIGNATURES**

Pursuant to the requirements of the Securities and Exchange Act of 1934, the Registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**HOLLY ENERGY PARTNERS, L.P.**

(Registrant)

By: HEP LOGISTICS HOLDINGS, L.P.  
its General Partner

By: HOLLY LOGISTIC SERVICES, L.L.C.  
its General Partner

Date: August 3, 2007

/s/ P. Dean Ridenour

P. Dean Ridenour  
Vice President and Chief Accounting Officer  
and Director  
(Principal Accounting Officer)

/s/ Stephen J. McDonnell

Stephen J. McDonnell  
Vice President and Chief Financial Officer  
(Principal Financial Officer)

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