

HOLLY ENERGY PARTNERS LP
Form 10-Q
November 03, 2016

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

FORM 10-Q

(Mark One)

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

For the quarterly period ended September 30, 2016

OR

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

For the transition period from _____ to _____

Commission File Number: 1-32225

HOLLY ENERGY PARTNERS, L.P.

(Exact name of registrant as specified in its charter)

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

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

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

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

Yes No

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

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

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

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 October 28, 2016 was 62,780,503.

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FORWARD-LOOKING STATEMENTS

This Quarterly Report on Form 10-Q contains certain “forward-looking statements” within the meaning of the federal securities laws. All statements, other than statements of historical fact included in this Form 10-Q, including, but not limited to, those under “Results of Operations” and “Liquidity and Capital Resources” in Item 2 “Management’s Discussion and Analysis of Financial Condition and Results of Operations” in Part I are forward-looking statements.

Forward-looking statements use words such as “anticipate,” “project,” “expect,” “plan,” “goal,” “forecast,” “intend,” “should,” “could,” “believe,” “may,” and similar expressions and statements regarding our plans and objectives for future operations.

These statements are based on our beliefs and assumptions and those of our general partner using currently available information and expectations as of the date hereof, are not guarantees of future performance and involve certain risks and uncertainties. Although we and our general partner believe that such expectations reflected in such forward-looking statements are reasonable, neither we nor our general partner can give assurance that our expectations will prove to be correct. All statements concerning our expectations for future results of operations are based on forecasts for our existing operations and do not include the potential impact of any future acquisitions. Our forward-looking statements are subject to a variety of risks, uncertainties and assumptions. If one or more of these risks or uncertainties materialize, or if underlying assumptions prove incorrect, our actual results may vary materially from those anticipated, estimated, projected or expected. Certain factors could cause actual results to differ materially from results anticipated in the forward-looking statements. These factors include, but are not limited to:

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

Cautionary statements identifying important factors that could cause actual results to differ materially from our expectations are set forth in this Form 10-Q, including without limitation, the forward-looking statements that are referred to above. When considering forward-looking statements, you should keep in mind the known material risk factors and other cautionary statements set forth in our Annual Report on Form 10-K for the year ended December 31, 2015, in “Management’s Discussion and Analysis of Financial Condition and Results of Operations” and in “Risk Factors.” All forward-looking statements included in this Form 10-Q and all subsequent written or oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by these cautionary statements. The forward-looking statements speak only as of the date made and, other than as required by law, we undertake no obligation to publicly update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

HOLLY ENERGY PARTNERS, L.P.

CONSOLIDATED BALANCE SHEETS

(Unaudited)

(in thousands, except unit data)

	September 30, 2016	December 31, 2015 ⁽¹⁾
ASSETS		
Current assets:		
Cash and cash equivalents	\$ 7,208	\$ 15,013
Accounts receivable:		
Trade	7,072	8,593
Affiliates	29,511	32,482
	36,583	41,075
Prepaid and other current assets	4,238	5,054
Total current assets	48,029	61,142
Properties and equipment, net	1,054,158	1,059,179
Transportation agreements, net	68,593	73,805
Goodwill	256,498	256,498
Equity method investments	166,531	79,438
Other assets	10,688	13,703
Total assets	\$ 1,604,497	\$ 1,543,765
LIABILITIES AND EQUITY		
Current liabilities:		
Accounts payable:		
Trade	\$ 12,374	\$ 10,948
Affiliates	5,878	11,635
	18,252	22,583
Accrued interest	7,193	6,752
Deferred revenue	11,927	12,016
Accrued property taxes	6,963	3,764
Other current liabilities	2,791	3,809
Total current liabilities	47,126	48,924
Long-term debt	1,070,615	1,008,752
Other long-term liabilities	16,742	20,744
Deferred revenue	45,440	39,063
Class B unit	39,637	33,941
Equity:		
Partners' equity:		
Common unitholders (59,360,503 and 58,657,048 units issued and outstanding)	426,006	428,019

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at September 30, 2016 and December 31, 2015, respectively)

General partner interest (2% interest)	(135,641)	(130,297)
Accumulated other comprehensive income (loss)	(109	)	190)
Total partners' equity	290,256		297,912	
Noncontrolling interest	94,681		94,429	
Total equity	384,937		392,341	
Total liabilities and equity	\$ 1,604,497		\$ 1,543,765	

(1) Retrospectively adjusted as described in Note 1.

See accompanying notes.

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HOLLY ENERGY PARTNERS, L.P.
CONSOLIDATED STATEMENTS OF INCOME
(Unaudited)
(In thousands, except per unit data)

	Three Months Ended		Nine Months Ended	
	September 30, 2016	2015 ⁽¹⁾	September 30, 2016	2015 ⁽¹⁾
Revenues:				
Affiliates	\$77,398	\$73,716	\$239,423	\$214,268
Third parties	15,212	14,673	50,094	47,356
	92,610	88,389	289,517	261,624
Operating costs and expenses:				
Operations (exclusive of depreciation and amortization)	27,954	24,196	82,131	77,661
Depreciation and amortization	15,520	16,444	47,780	46,421
General and administrative	2,664	3,673	8,618	9,659
	46,138	44,313	138,529	133,741
Operating income	46,472	44,076	150,988	127,883
Other income (expense):				
Equity in earnings of equity method investments	3,767	1,269	10,155	2,634
Interest expense	(14,447)	(9,486)	(36,258)	(27,310)
Interest income	108	381	332	384
Gain on sale of assets and other	112	176	104	406
	(10,460)	(7,660)	(25,667)	(23,886)
Income before income taxes	36,012	36,416	125,321	103,997
State income tax benefit (expense)	(61)	(69)	(210)	(106)
Net income	35,951	36,347	125,111	103,891
Allocation of net income attributable to noncontrolling interests	(1,166)	(2,081)	(8,448)	(7,851)
Net income attributable to Holly Energy Partners	34,785	34,266	116,663	96,040
General partner interest in net income, including incentive distributions	(15,222)	(10,611)	(39,784)	(30,186)
Limited partners' interest in net income	\$19,563	\$23,655	\$76,879	\$65,854
Limited partners' per unit interest in earnings—basic and diluted	\$0.33	\$0.40	\$1.29	\$1.11
Weighted average limited partners' units outstanding	59,223	58,657	58,895	58,657

(1) Retrospectively adjusted as described in Note 1.

See accompanying notes.

HOLLY ENERGY PARTNERS, L.P.
 CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
 (Unaudited)
 (In thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015 ⁽¹⁾	2016	2015 ⁽¹⁾
Net income	\$35,951	\$36,347	\$125,111	\$103,891
Other comprehensive income:				
Change in fair value of cash flow hedging instruments	201	(787)	(737)	(2,373)
Reclassification adjustment to net income on partial settlement of cash flow hedge	95	526	438	1,585
Other comprehensive income (loss)	296	(261)	(299)	(788)
Comprehensive income before noncontrolling interest	36,247	36,086	124,812	103,103
Allocation of comprehensive income to noncontrolling interests	(1,166)	(2,081)	(8,448)	(7,851)
Comprehensive income attributable to Holly Energy Partners	\$35,081	\$34,005	\$116,364	\$95,252

(1) Retrospectively adjusted as described in Note 1.

See accompanying notes.

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HOLLY ENERGY PARTNERS, L.P.
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Unaudited)
(In thousands)

	Nine Months Ended September 30,	
	2016	2015 ⁽¹⁾
Cash flows from operating activities		
Net income	\$ 125,111	\$ 103,891
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	47,780	46,421
(Gain) loss on sale of assets	(121)	(351)
Amortization of deferred charges	2,294	1,425
Amortization of restricted and performance units	1,865	3,023
Distributions less than income from equity investments	(1,370)	(416)
(Increase) decrease in operating assets:		
Accounts receivable—trade	1,521	(1,094)
Accounts receivable—affiliates	2,971	7,800
Prepaid and other current assets	814	(146)
Increase (decrease) in operating liabilities:		
Accounts payable—trade	(5,757)	(2,943)
Accounts payable—affiliates	1,589	(1,525)
Accrued interest	441	(4,764)
Deferred revenue	6,288	7,092
Accrued property taxes	3,199	3,774
Other current liabilities	(1,020)	(365)
Other, net	(594)	3,773
Net cash provided by operating activities	185,011	165,595
Cash flows from investing activities		
Additions to properties and equipment	(48,224)	(55,812)
Purchase of El Dorado crude tanks	—	(27,500)
Purchase of interest in Cheyenne Pipeline	(42,550)	—
Purchase of interest in Frontier Pipeline	—	(54,641)
Proceeds from sale of assets	210	1,244
Distributions in excess of equity in earnings of equity investments	1,685	158
Other	(351)	—
Net cash used for investing activities	(89,230)	(136,551)
Cash flows from financing activities		
Borrowings under credit agreement	310,500	443,000
Repayments of credit agreement borrowings	(642,500)	(360,000)
Proceeds from issuance of Senior Notes	394,000	—
Contributions from HFC for El Dorado Operating acquisition	—	24,376
Contributions from general partner	470	—
Distribution to HFC for Osage acquisition	(1,245)	—
Proceeds from issuance of common units	22,791	—
Distributions to HEP unitholders	(138,798)	(125,242)

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Distributions to noncontrolling interest	(3,750)	(2,875)
Distribution to HFC for Tulsa tank acquisition	(39,500)	—
Contributions from HFC for Tulsa tank expenditures	99	824
Purchase of units for incentive grants	(784)	(247)
Deferred financing costs	(3,930)	—
Other	(939)	(854)
Net cash used by financing activities	(103,586)	(21,018)
Cash and cash equivalents		
Increase (decrease) for the period	(7,805)	8,026
Beginning of period	15,013	2,830
End of period	\$7,208	\$10,856

(1) Retrospectively adjusted as described in Note 1.
See accompanying notes.

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HOLLY ENERGY PARTNERS, L.P.
CONSOLIDATED STATEMENTS OF EQUITY
(Unaudited)
(In thousands)

	Common Units	General Partner Interest	Accumulated Other Comprehensive Income (Loss)	Noncontrolling Interest	Total Equity
Balance December 31, 2015 ⁽¹⁾	\$428,019	\$(130,297)	\$ 190	\$ 94,429	\$392,341
Contribution from HFC for Osage transaction	—	31,287	—	—	31,287
Contribution from HFC	—	471	—	—	471
Distribution to HFC for Tulsa tank acquisition	—	(39,500)	—	—	(39,500)
Contribution from HFC for Tulsa tank expenditures	—	99	—	—	99
Distributions to HEP unitholders	(101,427)	(37,371)	—	—	(138,798)
Distributions to noncontrolling interest	—	—	—	(3,750)	(3,750)
Issuance of common units	22,590	—	—	—	22,590
Purchase of units for incentive grants	(784)	—	—	—	(784)
Amortization of restricted and performance units	1,865	—	—	—	1,865
Class B unit accretion	(5,582)	(114)	—	—	(5,696)
Net income	81,325	39,784	—	4,002	125,111
Other comprehensive loss	—	—	(299)	—	(299)
Balance September 30, 2016	\$426,006	\$(135,641)	\$ (109)	\$ 94,681	\$384,937

(1) Retrospectively adjusted as described in Note 1.

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 which is 39% owned (including the 2% general partner interest) by HollyFrontier Corporation (“HFC”) and its subsidiaries as of September 30, 2016. We commenced operations on July 13, 2004, upon the completion of our initial public offering. In these consolidated financial statements, the words “we,” “our,” “ours” and “us” refer to HEP unless the context otherwise indicates.

We operate in one reportable segment which represents the aggregation of our petroleum product and crude pipelines business and terminals, tankage, loading rack facilities and refinery processing units.

We own and operate petroleum product and crude oil pipelines, terminals, tankage and loading rack facilities and refinery processing units that support HFC’s refining and marketing operations in the Mid-Continent, Southwest and Rocky Mountain regions of the United States and Alon USA, Inc.’s (“Alon”) refinery in Big Spring, Texas. Additionally, we own a 75% interest in UNEV Pipeline, LLC (“UNEV”), a 50% interest in Frontier Aspen, LLC, a 50% interest in Osage Pipe Line Company, LLC (“Osage”), a 50% interest in Cheyenne Pipeline LLC and a 25% interest in SLC Pipeline LLC.

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

The consolidated financial statements included herein have been prepared without audit, pursuant to the rules and regulations of the United States Securities and Exchange Commission (the “SEC”). The interim financial statements reflect all adjustments, which, in the opinion of management, are necessary for a fair presentation of our results for the interim periods. Such adjustments are considered to be of a normal recurring nature. Although certain notes and other information required by U.S. generally accepted accounting principles (“GAAP”) have been condensed or omitted, we believe that the disclosures in these consolidated financial statements are adequate to make the information presented not misleading. These consolidated financial statements should be read in conjunction with our Annual Report on Form 10-K for the year ended December 31, 2015. 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, 2016.

On September 16, 2016, we entered into a common unit purchase agreement in which certain purchasers agreed to purchase in a private placement 3,420,000 common units representing limited partnership interests, at a price of \$30.18 per common unit. The private placement closed on October 3, 2016, and we received proceeds of approximately \$103 million, which were used to finance a portion of the Woods Cross acquisition discussed below. The purchase agreement is classified as an equity transaction, and as a result, no amounts are recorded in the consolidated financial statements until settlement. As a result of the private placement, HFC now owns a 37% interest in us (including the 2% general partner interest). To maintain the 2% general partner interest, HFC contributed \$2.1 million to HEP in October 2016. Additionally, we entered into a registration rights agreement with the purchasers, which requires that we file a registration statement with the SEC within 60 days following the closing of the private placement to register the purchased units under the Securities Act. The registration statement will be automatically effective and the units fully transferable upon filing.

On July 19, 2016, we closed a private placement of \$400 million in aggregate principal amount of 6% senior unsecured notes due in 2024 (the “6% Senior Notes”). We used the net proceeds to repay indebtedness under our revolving credit agreement.

On May 10, 2016, we established a continuous offering program under which HEP may issue and sell common units from time to time, representing limited partner interests, up to an aggregate gross sales amount of \$200 million. We intend to use our net proceeds for general partnership purposes.

Acquisitions

Woods Cross Operating

Effective October 1, 2016, we acquired all the membership interests of Woods Cross Operating LLC (“Woods Cross Operating”), a wholly owned subsidiary of HFC, which owns the newly constructed atmospheric distillation tower, fluid catalytic cracking unit, and polymerization unit located at HFC’s Woods Cross Refinery, for cash consideration of \$278 million. The consideration was funded with approximately \$103 million in proceeds from the private placement and the balance with borrowings under our credit

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

facility. In connection with this transaction, we entered into 15-year tolling agreements containing minimum quarterly throughput commitments from HFC that provide minimum annualized revenues of \$56.7 million.

The Utah Division of Air Quality issued an air quality permit to HollyFrontier Woods Cross Refining LLC (“HFC Woods Cross Refining”) authorizing the expansion units at the Woods Cross Refinery. The appeal proceeding challenging the Utah Department of Environmental Quality’s decision to uphold the air quality permit is still pending. The purchase agreement provides us with the option to compel HFC Woods Cross Refining to repurchase the interests for the full purchase price paid if the assets are required to be idled for 90 or more days as a result of a final decision in the appeal proceedings. If we do not exercise the foregoing right and, by reason of the appeal proceedings, the assets must be modified, then HFC will be responsible for the costs of such modifications.

As we are a consolidated variable interest entity (“VIE”) of HFC, this transaction will be recorded as a transfer between entities under common control and reflect HFC’s carrying basis in the net assets acquired. Also, during the fourth quarter of 2016, we will retrospectively adjust our financial position and operating results as if Wood Cross Operating were a consolidated subsidiary for all periods while we were under common control of HFC. Assuming this acquisition was effective as of September 30, 2016, our assets, liabilities and equity would have been retrospectively adjusted to include Woods Cross Operating’s assets, liabilities and equity as presented below:

	September 30, 2016	December 31, 2015
	(In thousands)	
Properties and equipment, net	\$278,375	\$253,829
Accounts payable	\$—	\$13,155
Partners’ equity	\$278,375	\$240,674

This retrospective adjustment will not have significant impact on our operating results prior to September 30, 2016, since the units became operational in the second and third quarters of 2016.

Cheyenne Pipeline

On June 3, 2016, we acquired a 50% interest in Cheyenne Pipeline LLC, owner of the Cheyenne Pipeline, in exchange for a contribution of \$42.6 million in cash to Cheyenne Pipeline LLC. Cheyenne Pipeline LLC will continue to be operated by an affiliate of Plains All American Pipeline, L.P. (“Plains”), which owns the remaining 50% interest. The 87-mile crude oil pipeline runs from Fort Laramie to Cheyenne, Wyoming and has an 80,000 barrel per day (“bpd”) capacity.

Tulsa Tanks

On March 31, 2016, we acquired crude oil tanks located at HFC’s Tulsa refinery from an affiliate of Plains for \$39.5 million. In 2009, HFC sold these tanks to Plains and leased them back, and due to HFC’s continuing interest in the tanks, HFC accounted for the transaction as a financing arrangement. Accordingly, the tanks remained on HFC’s balance sheet and were depreciated for accounting purposes.

As we are a consolidated VIE of HFC, this transaction was recorded as a transfer between entities under common control and reflects HFC’s carrying basis in the net assets acquired. We have retrospectively adjusted our financial position and operating results as if these crude oil tanks were owned for all periods while we were under common control of HFC. The 2015 consolidated income statement was adjusted to reflect a \$0.2 million and a \$0.6 million

increase in operating costs and expenses for the three and nine months ended September 30, 2015, respectively. The consolidated balance sheet was adjusted to reflect increases of \$9.3 million in net properties and equipment, \$0.1 million in other long-term liabilities and \$9.2 million in general partner interest at December 31, 2015. The consolidated statement of cash flows for the nine months ended September 30, 2015, reflects these changes in cash flows from investing and financing activities.

Osage

On February 22, 2016, HFC obtained a 50% membership interest in Osage in a non-monetary exchange for a 20-year terminalling services agreement, whereby a subsidiary of Magellan Midstream Partners (“Magellan”) will provide terminalling services for all HFC products originating in Artesia, New Mexico requiring terminalling in or through El Paso, Texas. Osage is the owner of the Osage Pipeline, a 135-mile pipeline that transports crude oil from Cushing, Oklahoma to HFC’s El Dorado Refinery in Kansas

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

and also connects to the Jayhawk pipeline serving the CHS Inc. refinery in McPherson, Kansas. The Osage Pipeline is the primary pipeline supplying HFC's El Dorado refinery with crude oil.

Concurrent with this transaction, we entered into a non-monetary exchange with HFC, whereby we received HFC's interest in Osage in exchange for our El Paso terminal. Under this exchange, we agreed to build two connections on our south products pipeline system that will permit HFC access to Magellan's El Paso terminal. Effective upon the closing of this exchange, we are the named operator of the Osage Pipeline and are working to transition into that role. Since we are a consolidated VIE of HFC, this transaction was recorded as a transfer between entities under common control and reflects HFC's carrying basis of its 50% membership interest in Osage of \$44.5 million offset by our net carrying basis in the El Paso terminal of \$12.1 million with the difference treated as a contribution from HFC. The carrying value of our 50% membership interest in Osage of \$44.5 million exceeds the amount of the underlying equity in net assets recorded by Osage by \$33.1 million.

El Dorado Operating

On November 1, 2015, we acquired from a wholly owned subsidiary of HFC, all the outstanding membership interests in El Dorado Operating LLC ("El Dorado Operating"), which owns the newly constructed naphtha fractionation and hydrogen generation units at HFC's El Dorado refinery, for cash consideration of \$62.0 million. In connection with this transaction, we entered into 15-year tolling agreements containing minimum quarterly throughput commitments from HFC that provide minimum annualized revenues of \$15.2 million.

As we are a consolidated VIE of HFC, this transaction was recorded as a transfer between entities under common control and reflects HFC's carrying basis in El Dorado Operating's assets and liabilities. We have retrospectively adjusted our financial position and operating results as if El Dorado Operating were a consolidated subsidiary for all periods while we were under common control of HFC. The consolidated statement of cash flows for the nine months ending September 30, 2015, reflects a \$24.4 million recast between investing activities and financing activities.

Frontier Pipeline

On August 31, 2015, we purchased a 50% interest in Frontier Aspen LLC (formerly known as Frontier Pipeline Company), which owns a 289-mile crude oil pipeline running from Casper, Wyoming to Frontier Station, Utah (the "Frontier Pipeline"), from an affiliate of Enbridge, Inc. for cash consideration of \$54.6 million. Frontier Pipeline will continue to be operated by an affiliate of Plains All American Pipeline, L.P., which owns the remaining 50% interest. The Frontier Pipeline has a 72,000 bpd capacity and supplies Canadian and Rocky Mountain crudes to Salt Lake City area refiners through a connection to the SLC Pipeline.

New Accounting Pronouncements

Revenue Recognition

In May 2014, an accounting standard update was issued requiring revenue to be recognized when promised goods or services are transferred to customers in an amount that reflects the expected consideration for these goods or services. This standard has an effective date of January 1, 2018. We are evaluating the impact of this standard.

Consolidation

In February 2015, the FASB issued a standard that modifies existing consolidation guidance for reporting organizations that are required to evaluate whether they should consolidate certain legal entities. We adopted the new

standard effective January 1, 2016. This standard had no impact on the entities we consolidate.

Financial Assets and Liabilities

In January 2016, an accounting standard update was issued requiring changes in the accounting and disclosures for financial instruments. This standard will become effective beginning with our 2018 reporting year. We are evaluating the impact of this standard.

Leases

In February 2016, an accounting standard update was issued requiring leases to be measured and recognized as a lease liability, with a corresponding right-of-use asset on the balance sheet. This standard has an effective date of January 1, 2019, and we are evaluating the impact of this standard.

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

Earnings Per Unit

In April 2015, an accounting standard update was issued requiring changes to the allocation of the earnings or losses of a transferred business for periods before the date of a dropdown of net assets accounted for as a common control transaction entirely to the general partner for purposes of calculating historical earnings per unit. We adopted this standard as of January 1, 2016. In connection with the dropdown of assets from HFC's Tulsa refinery on March 31, 2016, we reduced net income by \$0.2 million and \$0.6 million for the three and nine months ended September 30, 2015, respectively. This reduction had no impact on the historical earnings per unit.

Share-Based Compensation

In March 2016, Accounting Standard Update ("ASU") 2016-09, "Improvements to Employee Share-Based Payment Accounting," was issued which simplifies the accounting for employee share-based payment transactions, including the accounting for income taxes, forfeitures and statutory tax withholding requirements, as well as classification in the statement of cash flows. This standard is effective January 1, 2017, and will have an immaterial impact to our financial condition, results of operations and cash flows.

Note 2: Financial Instruments

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

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

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

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

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

The carrying amounts and estimated fair values of our senior notes and interest rate swaps were as follows:

Financial Instrument	Fair Value Input Level	September 30, 2016		December 31, 2015	
		Carrying Value	Fair Value	Carrying Value	Fair Value
(In thousands)					
Assets:					
Interest rate swaps	Level 2	\$—	\$—	\$304	\$304
Liabilities:					
6.5% Senior notes	Level 2	\$297,327	\$308,250	\$296,752	\$295,500

6% Senior notes		393,288	412,000	—	—
Interest rate swaps	Level 2	109	109	114	114
		\$690,724	\$720,359	\$296,866	\$295,614

Level 2 Financial Instruments

Our senior notes and interest rate swaps are measured at fair value using Level 2 inputs. The fair value of the senior notes is based on market values provided by a third-party bank, which were derived using market quotes for similar type debt instruments. The fair value of our interest rate swaps is based on the net present value of expected future cash flows related to both variable and fixed-rate legs of the swap agreement. This measurement is computed using the forward London Interbank Offered Rate (“LIBOR”) yield curve, a market-based observable input.

See Note 6 for additional information on these instruments.

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Note 3: Properties and Equipment

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

	September 30, 2016	December 31, 2015 ⁽¹⁾
	(In thousands)	
Pipelines, terminals and tankage	\$1,202,357	\$1,231,597
Land and right of way	65,274	66,215
Refinery assets	64,371	63,336
Construction in progress	62,247	28,249
Other	25,831	22,200
	1,420,080	1,411,597
Less accumulated depreciation	365,922	352,418
	\$1,054,158	\$1,059,179

(1) Retrospectively adjusted as described in Note 1.

We capitalized \$0.5 million and \$0.7 million in interest attributable to construction projects during the nine months ended September 30, 2016 and 2015, respectively.

Depreciation expense was \$42.1 million and \$40.8 million for the nine months ended September 30, 2016 and 2015, respectively.

Note 4: Transportation Agreements

Our transportation agreements represent a portion of the total purchase price of certain assets acquired from Alon in 2005 and from HFC in 2008. The Alon agreement is being amortized over 30 years ending 2035 (the initial 15-year term of the agreement plus an expected 15-year extension period), and the HFC agreement is being amortized over 15 years ending 2023 (the term of the HFC agreement).

The carrying amounts of our transportation agreements are as follows:

	September 30, 2016	December 31, 2015
	(In thousands)	
Alon transportation agreement	\$59,933	\$ 59,933
HFC transportation agreement	74,231	74,231
Other	50	50
	134,214	134,214
Less accumulated amortization	65,621	60,409
	\$68,593	\$ 73,805

Amortization expense was \$5.2 million for each of the nine months ended September 30, 2016 and 2015.

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

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Note 5: Employees, Retirement and Incentive Plans

Direct support for our operations is provided by Holly Logistic Services, L.L.C. (“HLS”), an HFC subsidiary, which utilizes personnel employed by HFC who are dedicated to performing services for us. Their costs, including salaries, bonuses, payroll taxes, benefits and other direct costs, are charged to us monthly in accordance with an omnibus agreement that we have with HFC. These employees participate in the retirement and benefit plans of HFC. Our share of retirement and benefit plan costs was \$1.4 million and \$1.4 million for the three months ended September 30, 2016 and 2015, respectively, and \$4.3 million and \$4.1 million for the nine months ended September 30, 2016 and 2015, respectively.

Under HLS’s secondment agreement with HFC (the “Secondment Agreement”), certain employees of HFC are seconded to HLS to provide operational and maintenance services for certain of our processing, refining, pipeline and tankage assets, and HLS reimburses HFC for its prorated portion of the wages, benefits, and other costs related to these employees.

We have a Long-Term Incentive Plan for employees and non-employee directors who perform services for us. The Long-Term Incentive Plan consists of four components: restricted or phantom units, performance units, unit options and unit appreciation rights.

As of September 30, 2016, we have two types of incentive-based awards outstanding, which are described below. The compensation cost charged against income was \$0.7 million and \$1.3 million for the three months ended September 30, 2016 and 2015, respectively, and \$1.9 million and \$2.9 million for the nine months ended September 30, 2016 and 2015, respectively. We currently purchase units in the open market instead of issuing new units for settlement of all unit awards under our Long-Term Incentive Plan. As of September 30, 2016, 2,500,000 units were authorized to be granted under our Long-Term Incentive Plan, of which 1,487,162 have not yet been granted, assuming no forfeitures of the unvested units and full achievement of goals for the unvested performance units.

Restricted and Phantom Units

Under our Long-Term Incentive Plan, we grant restricted units to non-employee directors and selected employees who perform services for us, with most awards vesting over a period of one to three years. Although full ownership of the units does not transfer to the recipients until the units vest, the recipients have distribution and voting rights on these units from the date of grant.

In addition, we previously granted phantom units to certain employees. All outstanding phantom units vested in 2015, and no phantom units are currently outstanding. Vested units were paid in common units. Full ownership of the units transferred to the recipients at vesting, and the recipients did not have voting or distribution rights on these units until they vested.

The fair value of each restricted unit award is measured at the market price as of the date of grant and is amortized on a straight-line basis over the requisite service period for each separately vesting portion of the award.

A summary of restricted unit activity and changes during the nine months ended September 30, 2016, is presented below:

Restricted Units	Units	Weighted Average
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		Grant-Date Fair Value
Outstanding at January 1, 2016 (nonvested)	101,408	\$ 33.63
Granted	12,231	25.65
Vesting and transfer of common units to recipients	(4,547)	33.01
Forfeited	(3,849)	34.21
Outstanding at September 30, 2016 (nonvested)	105,243	\$ 32.71

As of September 30, 2016, there was \$1.1 million of total unrecognized compensation expense related to nonvested restricted unit grants, which is expected to be recognized over a weighted-average period of 1 year.

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Performance Units

Under our Long-Term Incentive Plan, we grant performance units to selected executives who perform services for us. Performance units granted are payable in common units at the end of a three-year performance period based upon the growth in our distributable cash flow per common unit over the performance period. As of September 30, 2016, estimated unit payouts for outstanding nonvested performance unit awards ranged between 125% and 150% of the target number of performance units granted.

We granted 10,725 performance units during the nine months ended September 30, 2016. Performance units granted in 2015 and during the nine months ended September 30, 2016, vest over a three-year performance period ending December 31, 2018 and are payable in HEP common units. The number of units actually earned will be based on the growth of our distributable cash flow per common unit over the performance period, and can range from 50% to 150% of the target number of performance units granted. Although common units are not transferred to the recipients until the performance units vest, the recipients have distribution rights with respect to the common units from the date of grant.

A summary of performance unit activity and changes during the nine months ended September 30, 2016, is presented below:

Performance Units	Units
Outstanding at January 1, 2016 (nonvested)	45,494
Granted	10,725
Vesting and transfer of common units to recipients	(26,157)
Forfeited	(2,679)
Outstanding at September 30, 2016 (nonvested)	27,383

The grant-date fair value of performance units vested and transferred to recipients during the nine months ended September 30, 2016, was \$1.1 million. Based on the weighted average fair value of performance units outstanding at September 30, 2016, of \$0.8 million, there was \$0.6 million of total unrecognized compensation expense related to nonvested performance units, which is expected to be recognized over a weighted-average period of 1.9 years.

Note 6: Debt

Credit Agreement

In March 2016, we amended our senior secured revolving credit facility (the “Credit Agreement”) expiring in November 2018, increasing the size of the Credit Agreement from \$850 million to \$1.2 billion. The Credit Agreement is available to fund capital expenditures, investments, acquisitions, distribution payments and working capital and for general partnership purposes. It is also available to fund letters of credit up to a \$50 million sub-limit.

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

The Credit Agreement imposes certain requirements on us with which we were in compliance as of September 30, 2016, 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 into a merger or consolidation, or sell assets; and covenants that require maintenance of a specified EBITDA to interest expense ratio, total debt to EBITDA ratio and senior debt to EBITDA ratio. If an event of default exists under the Credit Agreement, the lenders will be able to accelerate the maturity of the debt and exercise other rights and remedies. We were in compliance with the covenants as of September 30, 2016.

Senior Notes

We have \$300 million in aggregate principal amount outstanding of 6.5% senior notes (the “6.5% Senior Notes”) maturing March 2020.

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On July 19, 2016, we closed a private placement of \$400 million in aggregate principal amount of 6% senior unsecured notes due in 2024 (the “6% Senior Notes” and together with the 6.5% Senior Notes, the “Senior Notes”). We used the net proceeds to repay indebtedness under our revolving credit agreement.

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. We were in compliance with the restrictive covenants for the Senior Notes as of September 30, 2016. 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 at varying premiums over face value under the Senior Notes.

Indebtedness under the Senior Notes is guaranteed by our wholly-owned subsidiaries.

Long-term Debt

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

	September 30 2016	December 31, 2015
	(In thousands)	
Credit Agreement		
Amount outstanding	\$ 380,000	\$ 712,000
6% Senior Notes		
Principal	400,000	—
Unamortized debt issuance costs	(6,712) —
	393,288	—
6.5% Senior Notes		
Principal	300,000	300,000
Unamortized discount and debt issuance costs	(2,673	) (3,248
	297,327	296,752
Total long-term debt	\$ 1,070,615	\$ 1,008,752

Interest Rate Risk Management

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

As of September 30, 2016, we have two interest rate swaps with identical terms that hedge our exposure to the cash flow risk caused by the effects of LIBOR changes on \$150 million of Credit Agreement advances. The swaps effectively convert \$150 million of our LIBOR based debt to fixed rate debt having an interest rate of 0.74% plus an applicable margin of 2.25% as of September 30, 2016, which equaled an effective interest rate of 2.99%. Both of these swap contracts mature in July 2017.

We have designated these interest rate swaps as cash flow hedges. Based on our assessment of effectiveness using the change in variable cash flows method, we have determined these interest rate swaps are effective in offsetting the variability in interest payments on \$150 million of our variable rate debt resulting from changes in LIBOR. Under

hedge accounting, we adjust our cash flow hedges on a quarterly basis to their fair values with the offsetting fair value adjustments to accumulated other comprehensive income (loss). Also on a quarterly basis, we measure hedge effectiveness by comparing the present value of the cumulative change in the expected future interest to be paid or received on the variable leg of our swaps against the expected future interest payments on \$150 million of our variable rate debt. Any ineffectiveness is recorded directly to interest expense. As of September 30, 2016, we had no ineffectiveness on our cash flow hedges.

At September 30, 2016, we have accumulated other comprehensive loss of \$0.1 million that relates to our current cash flow hedging instruments. Approximately \$0.1 million will be transferred from accumulated other comprehensive loss into interest expense as interest is paid on the underlying swap agreement over the next twelve-month period, assuming interest rates remain unchanged.

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Additional information on our interest rate swaps is as follows:

Derivative Instrument	Balance Sheet Location (In thousands)	Fair Value	Location of Offsetting Balance	Offsetting Amount
September 30, 2016				
Interest rate swaps designated as cash flow hedging instrument:				
Variable-to-fixed interest rate swap contracts (\$150 million of LIBOR-based debt interest)	Other current liabilities	\$ (109)	Accumulated other comprehensive income	\$ (109)
		\$ (109)		\$ (109)
December 31, 2015				
Interest rate swaps designated as cash flow hedging instrument:				
Variable-to-fixed interest rate swap contract (\$150 million of LIBOR-based debt interest)	Other long-term assets	\$ 304	Accumulated other comprehensive loss	\$ 304
Variable-to-fixed interest rate swap contracts (\$155 million of LIBOR-based debt interest)	Other long-term liabilities	(114)	Accumulated other comprehensive income	(114)
		\$ 190		\$ 190

Interest Expense and Other Debt Information

Interest expense consists of the following components:

	Nine Months Ended September 30,	
	2016	2015
	(In thousands)	
Interest on outstanding debt:		
Credit Agreement, net of interest on interest rate swaps	\$ 13,600	\$ 11,447
6.5% Senior Notes	14,632	14,631
6% Senior Notes	4,811	—
Amortization of discount and deferred debt issuance costs	2,294	1,425
Commitment fees and other	1,419	475
Total interest incurred	36,756	27,978
Less capitalized interest	498	668
Net interest expense	\$ 36,258	\$ 27,310
Cash paid for interest	\$ 33,896	\$ 31,165

Capital Lease Obligations

Our capital lease obligations, which relate to vehicle leases with initial terms of 33 to 48 months, are \$2.5 million and \$1.8 million as of September 30, 2016 and December 31, 2015, respectively. The total cost of assets under capital leases was \$4.7 million and \$3.0 million as of September 30, 2016 and December 31, 2015, respectively, with accumulated depreciation of \$2.0 million and \$1.1 million as of September 30, 2016 and December 31, 2015, respectively. We include depreciation of capital leases in depreciation and amortization in our consolidated statements of income.

Note 7: Significant Customers

All revenues are domestic revenues, of which 92% are currently generated from our two largest customers: HFC and Alon.

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

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	Three Months Ended September 30, 2016	2015	Nine Months Ended September 30, 2016	2015
HFC	84 %	84 %	83 %	82 %
Alon	8 %	9 %	8 %	10 %

Note 8: Related Party Transactions

We serve HFC's refineries under long-term pipeline, terminal and tankage throughput agreements, and refinery processing unit tolling agreements expiring from 2019 to 2036. Under these agreements, HFC agrees to transport, store and process throughput volumes of refined product, crude oil and feedstocks on our pipelines, terminals, tankage, loading rack facilities and refinery processing units that result in minimum annual payments to us. These minimum annual payments or revenues are subject to annual rate adjustments on July 1st each year based on the Producer Price Index ("PPI") or Federal Energy Regulatory Commission ("FERC") index. As of September 30, 2016, these agreements with HFC require minimum annualized payments to us of \$321.1 million.

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

Under certain provisions of an omnibus agreement we have with HFC (the "Omnibus Agreement"), we pay HFC an annual administrative fee (currently \$2.5 million) for the provision by HFC or its affiliates of various general and administrative services to us. This fee does not include the salaries of personnel employed by HFC who perform services for us on behalf of HLS or the cost of their employee benefits, which are charged to us separately by HFC. Also, we reimburse HFC and its affiliates for direct expenses they incur on our behalf.

Related party transactions with HFC are as follows:

Revenues received from HFC were \$77.4 million and \$73.7 million for the three months ended September 30, 2016 and 2015, respectively, and \$239.4 million and \$214.3 million for the nine months ended September 30, 2016 and 2015, respectively.

HFC charged us general and administrative services under the Omnibus Agreement of \$0.6 million for each of the three months ended September 30, 2016 and 2015 and \$1.8 million for each of the nine months ended September 30, 2016 and 2015.

We reimbursed HFC for costs of employees supporting our operations of \$10.0 million and \$8.5 million for the three months ended September 30, 2016 and 2015, respectively, and \$29.4 million and \$24.7 million for the nine months ended September 30, 2016 and 2015, respectively.

HFC reimbursed us \$4.5 million and \$3.0 million for the three months ended September 30, 2016 and 2015, respectively, for expense and capital projects and \$11.2 million and \$10.0 million for the nine months ended

September 30, 2016 and 2015, respectively.

We distributed \$26.2 million and \$22.9 million for the three months ended September 30, 2016 and 2015, respectively, and \$76.0 million and \$66.8 million for the nine months ended September 30, 2016 and 2015, respectively, to HFC as regular distributions on its common units and general partner interest, including general partner incentive distributions.

- Accounts receivable from HFC were \$29.5 million and \$32.5 million at September 30, 2016, and December 31, 2015, respectively.

Accounts payable to HFC were \$5.9 million and \$11.6 million at September 30, 2016, and December 31, 2015, respectively.

Revenues for the nine months ended September 30, 2016 and 2015, include \$5.7 million and \$6.6 million, respectively, of shortfall payments billed to HFC in 2015 and 2014, respectively. Deferred revenue in the consolidated balance sheets at September 30, 2016, and December 31, 2015, includes \$4.6 million and \$6.4 million, respectively, relating to certain

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shortfall billings. It is possible that HFC may not exceed its minimum obligations to receive credit for any of the \$4.6 million deferred at September 30, 2016.

On February 22, 2016, HFC obtained a 50% membership interest in Osage in a non-monetary exchange, whereby a subsidiary of Magellan will provide terminalling services for all HFC products originating in Artesia, New Mexico that require terminalling in or through El Paso, Texas. Concurrent with this transaction, we entered into a non-monetary exchange with HFC, whereby we received HFC's interest in Osage in exchange for our El Paso terminal. See Note 1 for a description of this transaction.

On March 31, 2016, we acquired crude oil tanks located at HFC's Tulsa refinery from an affiliate of Plains for \$39.5 million. See Note 1 for a description of this transaction.

Effective October 1, 2016, we acquired all the membership interests of Woods Cross Operating LLC ("Woods Cross Operating"), a wholly owned subsidiary of HFC, which owns the newly constructed atmospheric distillation tower, fluid catalytic cracking unit, and polymerization unit located at HFC's Woods Cross Refinery, for cash consideration of \$278 million. See Note 1 for a description of this transaction.

Note 9: Partners' Equity

As of September 30, 2016, HFC held 22,380,030 of our common units and the 2% general partner interest, which together constituted a 39% ownership interest in us. Additionally, HFC owned all incentive distribution rights in us.

Common Unit Private Placement

On September 16, 2016, we entered into a common unit purchase agreement in which certain purchasers agreed to purchase in a private placement 3,420,000 common units representing limited partnership interests, at a price of \$30.18 per common unit.

The private placement closed on October 3, 2016, and we received proceeds of approximately \$103 million, which were used to finance a portion of the Woods Cross acquisition discussed below. The purchase agreement is classified as an equity transaction, and as a result, no amounts are recorded in the consolidated financial statements until settlement. As a result of the private placement, HFC now owns a 37% interest in us (including the 2% general partner interest). To maintain the 2% general partner interest, HFC contributed \$2.1 million in October 2016.

Continuous Offering Program

On May 10, 2016, we established a continuous offering program under which HEP may issue and sell common units from time to time, representing limited partner interests, up to an aggregate gross sales amount of \$200 million. As of September 30, 2016, HEP has issued 703,455 units under this program, providing \$23.5 million in gross proceeds. We incurred sales commissions of \$0.5 million associated with the issuance of these units. In connection with this program and to maintain the 2% general partner interest, HFC made capital contributions totaling \$0.5 million as of September 30, 2016.

We intend to use our net proceeds for general partnership purposes, which may include funding working capital, repayment of debt, acquisitions and capital expenditures. Amounts repaid under our credit facility may be reborrowed from time to time.

Allocations of Net Income

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

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

	Three Months		Nine Months	
	Ended September		Ended	
	30,		September 30,	
	2016	2015	2016	2015
	(In thousands)			
General partner interest in net income	\$399	\$264	\$1,352	\$695
General partner incentive distribution	14,823	10,347	38,432	29,491
Total general partner interest in net income	\$15,222	\$10,611	\$39,784	\$30,186

Cash Distributions

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

On October 21, 2016, we announced our cash distribution for the third quarter of 2016 of \$0.595 per unit. The distribution is payable on all common and general partner units and will be paid November 10, 2016, to all unitholders of record on October 31, 2016.

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

	Three Months		Nine Months Ended	
	Ended September		September 30,	
	30,		September 30,	
	2016	2015	2016	2015
	(In thousands, except per unit data)			
General partner interest in distribution	\$1,065	\$901	\$2,992	\$2,639
General partner incentive distribution	14,823	10,347	38,432	29,491
Total general partner distribution	15,888	11,248	41,424	32,130
Limited partner distribution	37,354	32,554	105,657	96,051
Total regular quarterly cash distribution	\$53,242	\$43,802	\$147,081	\$128,181
Cash distribution per unit applicable to limited partners	\$0.5950	\$0.5550	\$1.7550	\$1.6375

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

Note 10: Net Income Per Limited Partner Unit

Net income per unit applicable to the limited partners is computed using the two-class method, because we have more than one class of participating securities. The classes of participating securities as of September 30, 2016, included common units, general partner units and incentive distribution rights (IDRs). To the extent net income attributable to the partnership exceeds or is less than cash distributions, this difference is allocated based on the unitholders' respective ownership percentages, after consideration of any priority allocations of earnings.

When our financial statements are retrospectively adjusted after a dropdown transaction, the earnings of the acquired business or asset, prior to the closing of the transaction, are allocated entirely to our general partner and presented as net income (loss) attributable to predecessors as shown below. The earnings per unit of our limited partners prior to the close of the transaction do

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not change as a result of the dropdown. After the closing of a dropdown transaction, the earnings of the acquired business are allocated in accordance with our partnership agreement as previously described.

For purposes of applying the two-class method including the allocation of cash distributions in excess of earnings, net income per limited partner unit is computed as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
	(In thousands)			
Net income attributable to Holly Energy Partners	\$34,785	\$34,266	\$116,663	\$96,040
Net loss attributable to predecessors	—	219	—	649
Net Income attributable to partnership	34,785	34,485	116,663	96,689
Less: General partner's distribution declared (including IDRs)	(15,888)	(11,248)	(41,424)	(32,130)
Limited partner's distribution declared on common units	(37,354)	(32,554)	(105,657)	(96,051)
Distributions in excess of net income attributable to partnership	\$(18,457)	\$(9,317)	\$(30,418)	\$(31,492)

	General Partner (including IDRs)	Limited Partners' Common Units	Total
		(In thousands, except per unit data)	
Three Months Ended September 30, 2016			
Net income attributable to partnership:			
Distributions declared	\$15,888	\$37,354	\$53,242
Distributions in excess of net income attributable to partnership	(369)	(18,088)	(18,457)
Net income attributable to partnership	\$15,519	\$19,266	\$34,785
Weighted average limited partners' units outstanding		59,223	
Limited partners' per unit interest in earnings - basic and diluted		\$0.33	

Three Months Ended September 30, 2015			
Net income attributable to partnership:			
Distributions declared	\$11,248	\$32,554	\$43,802
Distributions in excess of net income attributable to partnership	(186)	(9,131)	(9,317)
Net income attributable to partnership	\$11,062	\$23,423	\$34,485
Weighted average limited partners' units outstanding		58,657	
Limited partners' per unit interest in earnings - basic and diluted		\$0.40	

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	General Partner (including IDRs) (In thousands, except per unit data)	Limited Partners' Common Units	Total
Nine Months Ended September 30, 2016			
Net income attributable to partnership:			
Distributions declared	\$41,424	\$105,657	\$147,081
Distributions in excess of net income attributable to partnership	(608)	(29,810)	(30,418)
Net income attributable to partnership	\$40,816	\$75,847	\$116,663
Weighted average limited partners' units outstanding		58,895	
Limited partners' per unit interest in earnings - basic and diluted		\$1.29	
Nine Months Ended September 30, 2015			
Net income attributable to partnership:			
Distributions declared	\$32,130	\$96,051	\$128,181
Distributions in excess of net income attributable to partnership	(630)	(30,862)	(31,492)
Net income attributable to partnership	\$31,500	\$65,189	\$96,689
Weighted average limited partners' units outstanding		58,657	
Limited partners' per unit interest in earnings - basic and diluted		\$1.11	

Note 11: Environmental

We incurred no environmental remediation expense for long term environmental remediation projects for the three months ended September 30, 2016 and 2015. For the nine months ended September 30, 2016, we incurred \$0.2 million for environmental expense for long term environmental remediation projects, and we incurred \$4.2 million for the nine months ended September 30, 2015. The accrued environmental liability, net of expected recoveries from indemnifying parties, reflected in our consolidated balance sheets was \$7.0 million and \$7.7 million at September 30, 2016, and December 31, 2015, respectively, of which \$5.4 million and \$6.1 million, respectively, were classified as other long-term liabilities. These accruals include remediation and monitoring costs expected to be incurred over an extended period of time.

Under the Omnibus Agreement and certain transportation agreements and purchase agreements with HFC, HFC has agreed to indemnify us, subject to certain monetary and time limitations, for environmental noncompliance and remediation liabilities associated with certain assets transferred to us from HFC and occurring or existing prior to the date of such transfers. As of September 30, 2016, and December 31, 2015, our consolidated balance sheets included additional accrued environmental liabilities of \$1.0 million and \$6.4 million, respectively, for HFC indemnified liabilities, and other assets included equal and offsetting balances representing amounts due from HFC related to indemnifications for environmental remediation liabilities.

Note 12: Contingencies

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 operation or cash flows.

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

Note 13: Supplemental Guarantor/Non-Guarantor Financial Information

Obligations of HEP (“Parent”) under the Senior Notes have been jointly and severally guaranteed by each of its direct and indirect 100% owned subsidiaries (“Guarantor Subsidiaries”). These guarantees are full and unconditional, subject to certain customary release provisions. These circumstances include (i) when a Guarantor Subsidiary is sold or sells all or substantially all of its assets, (ii) when a Guarantor Subsidiary is declared “unrestricted” for covenant purposes, (iii) when a Guarantor Subsidiary’s guarantee of other indebtedness is terminated or released and (iv) when the requirements for legal defeasance or covenant defeasance or to discharge the Senior Notes have been satisfied.

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

In conjunction with the preparation of our September 30, 2016 Condensed Consolidating Balance Sheet and Statements of Comprehensive Income included below, we identified and corrected the presentation of noncontrolling interests previously presented in the eliminations column in prior periods to reflect such balances and activity within the respective guarantor and non-guarantor subsidiaries columns. This immaterial correction has been reflected in our current period Condensed Consolidating Financial Statements.

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

Condensed Consolidating Balance Sheet

September 30, 2016	Parent	Guarantor Restricted Subsidiaries	Non-Guarantor Non-Restricted Subsidiaries	Eliminations	Consolidated
	(In thousands)				
ASSETS					
Current assets:					
Cash and cash equivalents	\$2	\$—	\$ 7,206	\$—	\$ 7,208
Accounts receivable	—	33,045	3,713	(175	) 36,583
Prepaid and other current assets	46	2,924	1,268	—	4,238
Total current assets	48	35,969	12,187	(175	) 48,029
Properties and equipment, net	—	679,082	375,076	—	1,054,158
Investment in subsidiaries	986,828	284,041	—	(1,270,869) —
Transportation agreements, net	—	68,593	—	—	68,593
Goodwill	—	256,498	—	—	256,498
Equity method investments	—	166,531	—	—	166,531
Other assets	694	9,994	—	—	10,688
Total assets	\$987,570	\$ 1,500,708	\$ 387,263	\$(1,271,044)	\$ 1,604,497
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	\$—	\$ 15,892	\$ 2,535	\$(175	) \$ 18,252
Accrued interest	6,425	768	—	—	7,193
Deferred revenue	—	9,664	2,263	—	11,927
Accrued property taxes	—	3,411	3,552	—	6,963
Other current liabilities	7	2,774	10	—	2,791
Total current liabilities	6,432	32,509	8,360	(175	) 47,126
Long-term debt	690,615	380,000	—	—	1,070,615
Other long-term liabilities	267	16,294	181	—	16,742
Deferred revenue	—	45,440	—	—	45,440
Class B unit	—	39,637	—	—	39,637
Equity - partners	290,256	986,828	284,041	(1,270,869	) 290,256
Equity - noncontrolling interest	—	—	94,681	—	94,681
Total liabilities and equity	\$987,570	\$ 1,500,708	\$ 387,263	\$(1,271,044)	\$ 1,604,497

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

Condensed Consolidating Balance Sheet

December 31, 2015 ⁽¹⁾	Parent	Guarantor Restricted Subsidiaries	Non-Guarantor Non-Restricted Subsidiaries	Eliminations	Consolidated
	(In thousands)				
ASSETS					
Current assets:					
Cash and cash equivalents	\$2	\$ 5,452	\$ 9,559	\$—	\$ 15,013
Accounts receivable	—	35,558	5,715	(198	) 41,075
Prepaid and other current assets	174	3,634	1,246	—	5,054
Total current assets	176	44,644	16,520	(198	) 61,142
Properties and equipment, net	—	687,336	371,843	—	1,059,179
Investment in subsidiaries	600,563	283,287	—	(883,850) —
Transportation agreements, net	—	73,805	—	—	73,805
Goodwill	—	256,498	—	—	256,498
Equity method investments	—	79,438	—	—	79,438
Other assets	642	13,061	—	—	13,703
Total assets	\$601,381	\$ 1,438,069	\$ 388,363	\$(884,048	) \$ 1,543,765
LIABILITIES AND EQUITY					
Current liabilities:					
Accounts payable	\$—	\$ 19,448	\$ 3,333	\$(198	) \$ 22,583
Accrued interest	6,500	252	—	—	6,752
Deferred revenue	—	6,010	6,006	—	12,016
Accrued property taxes	—	2,627	1,137	—	3,764