HOLLY ENERGY PARTNERS LP
Form 10-K
February 26, 2007

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UNITED STATES SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-K
ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(D) OF THE SECURITIES EXCHANGE ACT OF 1934
For the fiscal year ended December 31, 2006
Commission File Number 1-32225
HOLLY ENERGY PARTNERS, L.P.
Formed under the laws of the State of Delaware
I.R.S. Employer Identification No. 20-0833098
100 Crescent Court, Suite 1600
Dallas, Texas 75201-6915
Telephone Number: (214) 871-3555
Securities registered pursuant to Section 12(b) of the Act:
Common Limited Partner Units
Securities registered pursuant to Section 12(g) of the Act:
None

Indicate by check mark whether the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act.

Yes o No þ

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act.

Yes o No þ

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

Yes þ No o

Indicate by check mark if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein, and will not be contained, to the best of registrant s knowledge, in definitive proxy or information statements incorporated by reference in part III of the Form 10-K or any amendments to the Form 10-K.

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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 o Accelerated filer þ Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes o No þ

The aggregate market value of common limited partner units held by non-affiliates of the registrant was approximately $327 million on June 30, 2006, based on the last sales price as quoted on the New York Stock Exchange.

The number of the registrant s outstanding common limited partners units at February 9, 2007 was 8,170,000.

DOCUMENTS INCORPORATED BY REFERENCE: None

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PART I

FORWARD-LOOKING STATEMENTS

This Annual Report on Form 10-K 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-K, including, but not limited to, those under Business , Risk Factors and Properties in Items 1, 1A and 2 and Management s Discussion an Analysis of Financial Condition and Results of Operations in Item 7, are forward-looking statements. These statements are based on management s belief 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 to be 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 any future acquired operations;
- 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-K, including without limitation, in conjunction with the forward-looking statements included in the Form 10-K 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 this Form 10-K under Risk Factors in Item 1A. All forward-looking statements included in this Form 10-K 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.

INDEX TO DEFINED TERMS AND NAMES

The following terms and names that appear in this form 10-K are defined on the following pages:

Terms used in the financial statements and footnotes are as defined therein.

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Item 1. Business

OVERVIEW

Holly Energy Partners, L.P. (HEP) is a Delaware limited partnership formed by Holly Corporation and is the successor to Navajo Pipeline Co., L.P. (Predecessor) (NPL). We operate a system of refined product pipelines and distribution terminals primarily in west Texas, New Mexico, Utah and Arizona. We maintain our principal corporate offices at 100 Crescent Court, Suite 1600, Dallas, Texas 75201-6915. Our telephone number is 214-871-3555 and our internet website address is www.hollyenergy.com. The information contained on our website does not constitute part of this Annual Report on Form 10-K. A copy of this Annual Report on Form 10-K will be provided without charge upon written request to the Vice President, Investor Relations at the above address. A direct link to our filings at the U.S. Securities and Exchange Commission (SEC) website is available on our website on the Investors page. Additionally available on our website are copies of our Corporate Governance Guidelines, Audit Committee Charter, Compensation Committee Charter, and Code of Business Conduct and Ethics, all of which will be provided without charge upon written request to the Vice President, Investor Relations at the above address. In this document, the words we , our , ours and us refer to HEP and its consolidated subsidiaries or to HEP or an individual subsidiary and not to any other person. Holly refers to Holly Corporation and its subsidiaries, other than HEP and its subsidiaries and other than Holly Logistic Services, L.L.C. (HLS), a subsidiary of Holly Corporation that is the general partner of the general partner of HEP and manages HEP.

HEP was formed to acquire, own and operate substantially all of the refined product pipeline and terminalling assets that support Holly s refining and marketing operations in west Texas, New Mexico, Utah and Arizona and a 70% interest in Rio Grande Pipeline Company (Rio Grande). On July 7, 2004, we priced 6,100,000 common units for the initial public offering and on July 8, 2004, our common units began trading on the New York Stock Exchange under the symbol HEP. On July 13, 2004, we closed our initial public offering of 7,000,000 common units at a price of $22.25 per unit, which included a 900,000 unit over-allotment option that was exercised by the underwriters.

On February 28, 2005, we closed on a contribution agreement with Alon USA, Inc. and several of its wholly-owned subsidiaries (collectively, Alon) that provided for our acquisition of four refined products pipelines, an associated tank farm and two refined products terminals located primarily in Texas. On July 8, 2005, we closed on a purchase agreement to acquire Holly s two 65-mile parallel intermediate feedstock pipelines (the Intermediate Pipelines) which connect its Lovington, New Mexico and Artesia, New Mexico refining facilities (collectively, the Navajo Refinery).

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. We serve Holly s refineries in New Mexico and Utah under two 15-year pipeline and terminal agreements with Holly. 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). We also serve Alon s Big Spring Refinery under the Alon Pipelines and Terminals Agreement expiring 2020 (Alon PTA). The substantial majority of our business is devoted to providing transportation and terminalling services to Holly. We operate our business as one business segment. Our assets include:

Pipelines:

- approximately 780 miles of refined product pipelines, including 340 miles of leased pipelines, that transport gasoline, diesel, and jet fuel principally from Holly s Navajo Refinery in New Mexico to its customers in the metropolitan and rural areas of Texas, New Mexico, Arizona, Colorado, Utah and northern Mexico;

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approximately 510 miles of refined product pipelines that transport refined products from Alon s Big Spring Refinery in Texas to customers in Texas and Oklahoma;

two parallel 65-mile pipelines that transport intermediate feedstocks and crude oil from Holly s Lovington, New Mexico refinery facilities to Holly s Artesia, New Mexico refinery facilities; and

a 70% interest in Rio Grande, a joint venture that owns a 249-mile refined product pipeline that transports liquid petroleum gases (LPG) from west Texas to the Texas/Mexico border near El Paso for further transport into northern Mexico.

Refined Product Terminals:

five refined product terminals (one of which is 50% owned), located in El Paso, Texas; Moriarty, Bloomfield and Albuquerque, New Mexico; and Tucson, Arizona, with an aggregate capacity of approximately 1.1 million barrels, that are integrated with our refined product pipeline system that serves Holly s Navajo Refinery;

three refined product terminals (two of which are 50% owned), located in Burley and Boise, Idaho and Spokane, Washington, with an aggregate capacity of approximately 500,000 barrels, that serve third-party common carrier pipelines;

one refined product terminal near Mountain Home, Idaho with a capacity of 120,000 barrels, that serves a nearby United States Air Force Base;

two refined product terminals, located in Wichita Falls and Abilene, Texas, and one tank farm in Orla, Texas with aggregate capacity of 480,000 barrels, that are integrated with our refined product pipelines that serve Alon s Big Spring, Texas refinery; and

two refined product truck loading racks, one located within Holly s Navajo Refinery that is permitted to load over 40,000 barrels per day (bpd) of light refined products, and one located within Holly s Woods Cross Refinery near Salt Lake City, Utah, that is permitted to load over 25,000 bpd of light refined products.

Historical Results of Operations

In reviewing the historical results of operations that are discussed below, you should be aware of the following:

The historical financial data prior to our commencement of operations on July 13, 2004 do not reflect any general and administrative expenses as Holly did not historically allocate any of its general and administrative expenses to its pipelines and terminals. Also, our historical results of operations prior to July 13, 2004 include revenues and costs associated with crude oil and intermediate product pipelines, which were not contributed to our partnership at its inception.

For periods after commencement of operations by HEP on July 13, 2004, our financial statements reflect:

net proceeds from our initial public offering which closed on July 13, 2004 (see Liquidity and Capital Resources in Management s Discussion and Analysis of Financial Condition and Results of Operations in Item 7);

the transfer of certain of our predecessor s operations to HEP, which

includes our predecessor s refined product pipeline and terminal assets and short-term debt due to Holly (which was repaid upon the closing of our initial public offering), and excludes our predecessor s intermediate product pipelines prior to our purchase of those pipelines in July 2005, crude oil systems, accounts receivable from or payable to affiliates, and other miscellaneous assets and liabilities;

the execution of the Holly PTA and the recognition of revenues derived therefrom for serving Holly s refineries in New Mexico and Utah; and

the execution of an omnibus agreement with Holly and several of its subsidiaries (the Omnibus Agreement) and the recognition of allocated general and administrative expenses in addition to direct general and administrative expense related to our operation as a publicly owned entity.

NPL constitutes HEP s predecessor. The transfer of ownership of assets from NPL to HEP represented a reorganization of entities under common control and was recorded at NPL s historical cost. Accordingly, our financial statements include the historical results of operations of NPL prior to the transfer to HEP.

Agreements with Holly

Under the 15-year Holly PTA, Holly pays us fees to transport on our refined product pipelines or throughput in our terminals a volume of refined products that will produce a minimum level of revenue. This minimum revenue commitment will 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, 2006 PPI adjustment, the volume commitments by Holly under the Holly PTA will produce at least $38.5 million of revenue for the twelve months ending June 30, 2007. Holly pays the published tariff rates on the refined product pipelines and contractually agreed upon fees at the terminals. The tariffs adjust annually at a rate equal to the percentage change in the PPI. The terminal fees will adjust annually based upon an index comprised of comparable fees posted by third parties. Holly s minimum revenue commitment applies only to the initial assets we acquired from Holly and may not be spread among assets we subsequently acquire. If Holly fails to meet its minimum revenue commitment 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.

Furthermore, if new laws or regulations that affect terminals or pipelines generally are enacted that require us to make substantial and unanticipated capital expenditures at the pipelines or terminals, we will have the right to negotiate a monthly surcharge on Holly for the use of the terminals or to file for an increased tariff rate for use of the pipelines to cover Holly s pro rata portion of the cost of complying with these laws or regulations, after we have made efforts to mitigate their effect. We and Holly will negotiate in good faith to agree on the level of the monthly surcharge or increased tariff rate.

Holly s obligations under this agreement may be proportionately reduced or suspended if Holly shuts down or materially reconfigures one of its refineries. Holly will be required to give at least twelve months advance notice of any long-term shutdown or material reconfiguration. Holly s obligations may also be temporarily suspended or terminated in certain circumstances.

Under the Omnibus Agreement, we pay Holly an annual administrative fee in the amount of $2.0 million for the provision of various general and administrative services for our benefit. The contract provides that this amount may be increased on the third anniversary following our initial public offering by the greater of 5% or the percentage increase in the consumer price index for the applicable year. Our general partner, with the approval and consent of its conflicts committee, also has the right to agree to further increases in connection with expansions of our operations through the acquisition or construction of new assets or businesses. Following the initial three-year period under this agreement, our general partner will determine the general and administrative expenses that will be charged to us. The $2.0 million fee includes expenses incurred by Holly and its affiliates to perform centralized corporate functions, such as executive management, legal, accounting, treasury, information technology and other corporate services, including the administration of employee benefit plans. This fee does not include the salaries of pipeline and terminal personnel or other employees of HLS 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

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Holly and its affiliates for direct expenses they incur on our behalf. In addition, we incur additional general and administrative costs, including costs relating to operating as a separate publicly held entity, such as costs for preparation of partners K-1 tax information, annual and quarterly reports to unitholders, investor relations, directors compensation, directors and officers insurance and registrar and transfer agent fees. Under the Omnibus Agreement, Holly also 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 for any environmental noncompliance and remediation liabilities associated with the assets transferred to us and occurring or existing prior to the closing date of our initial public offering.

Alon Transaction

On February 28, 2005, we acquired from 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.

The total consideration paid for these pipeline and terminal assets was $120.0 million in cash and 937,500 of our Class B subordinated units which, subject to certain conditions, will convert into an equal number of common units on February 28, 2010. We financed the Alon transaction with a portion of the proceeds of our private offering of $150.0 million principal amount of 6.25% senior notes due 2015 (the Senior Notes). In connection with the Alon transaction, we entered into the Alon PTA. Under this agreement, Alon agreed to transport on our pipelines and throughput in our terminals a volume of refined products that would result in minimum revenue levels each year that will change annually based on changes in the PPI, but will not decrease below the initial $20.2 million annual amount. Following the March 1, 2006 PPI adjustment, the volume commitments by Alon under the Alon PTA will produce at least $20.5 million of revenue for the twelve months ending February 28, 2007. The agreed upon tariffs increase or decrease each year at a rate equal to the percentage change in the PPI, but not below the initial tariffs. Alon s minimum volume commitment was calculated based on 90% of Alon s then recent usage of these pipelines and terminals taking into account an expansion of Alon s Big Spring Refinery completed in February 2005. At revenue levels above 105% of the base revenue amount, as adjusted each year for changes in the PPI, Alon will receive an annual 50% discount on incremental revenues. Alon s obligations under the Alon PTA may be reduced or suspended under certain circumstances. We granted Alon a second mortgage on the pipelines and terminals acquired from Alon to secure certain of Alon s rights under the Alon PTA. Alon has a right of first refusal to purchase the pipelines and terminals if we decide to sell them in the future. Additionally, we entered into an environmental agreement expiring in 2015 with Alon with respect to pre-closing environmental costs and liabilities relating to the pipelines and terminals acquired from Alon, whereby Alon will indemnify us subject to a $100,000 deductible and a $20.0 million maximum liability cap.

The consideration for the Alon pipeline and terminal assets was allocated to the individual assets acquired based on their estimated fair values. The allocation of the consideration is based on an independent appraisal. The aggregate consideration amounted to $146.7 million, which consisted of $24.7 million fair value of our Class B subordinated units, $120.0 million in cash and $2.0 million of transaction costs. In accounting for this acquisition, we recorded pipeline and terminal assets of $86.7 million and an intangible asset of $60.0 million, representing the allocated value of the 15-year Alon PTA. This intangible asset is included in Transportation agreements, net in our consolidated balance sheets.

Holly Intermediate Pipelines Transaction

On July 6, 2005, we entered into a definitive purchase agreement (the Purchase Agreement) with Holly to acquire Holly s Intermediate Pipelines which connect its Lovington, New Mexico and Artesia, New Mexico refining facilities. On July 8, 2005, we closed on the acquisition for $81.5 million, which consisted of $77.7 million in cash, 70,000 common units of HEP and a capital account credit of $1.0 million to maintain Holly s existing general partner interest in the Partnership. We financed the cash portion of the consideration for the Intermediate Pipelines with the proceeds raised from (a) the private sale of 1,100,000 of our common units for $45.1 million to a limited number of institutional investors which closed simultaneously with the acquisition and (b) an additional $35.0 million in principal amount of our 6.25% senior notes due 2015. This acquisition was made pursuant to an option to purchase these pipelines granted by Holly to us at the time of our initial public offering in July 2004.

In connection with this transaction, we entered into the Holly IPA, which expires in 2020. Under this agreement, Holly agreed to transport volumes of intermediate products on the Intermediate Pipelines that would result in initial minimum funds to us of $11.8 million each year that will change annually based on changes in the PPI but will not decrease as a result of a decrease in the PPI. Following the July 1, 2006 PPI adjustment, the volume commitments by Holly under the Holly IPA will result in minimum funds to us of $12.4 million annually. Holly s minimum revenue commitment applies only to the Intermediate Pipelines, and Holly is not able to spread its minimum revenue commitment among pipeline assets HEP already owns or subsequently acquires. If Holly fails to meet its minimum revenue commitment 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. The Holly IPA may be extended by the mutual agreement of the parties.

We agreed to expend up to $3.5 million to expand the capacity of the Intermediate Pipelines to meet the needs of Holly s expansion of their Navajo Refinery. As of December 31, 2006, this expansion project was complete and no further expenditures are expected under this obligation. If new laws or regulations are enacted that require us to make substantial and unanticipated capital expenditures with regard to the Intermediate Pipelines, we have the right to amend the tariff rates to recover our costs of complying with these new laws or regulations (including a reasonable rate of return). Under certain circumstances, either party may temporarily suspend its obligations under the Holly IPA.

We granted Holly a second mortgage on the Intermediate Pipelines to secure certain of Holly s rights under the Holly IPA. Holly agreed to provide $2.5 million of additional indemnification above the initial $15.0 million of indemnification under the Omnibus Agreement that previously provided for environmental noncompliance and remediation liabilities occurring or existing before the closing date of the Purchase Agreement, bringing the total indemnification, expiring in 2020, provided to us from Holly to $17.5 million. Of this total, indemnification above $15.0 million relates solely to the Intermediate Pipelines.

As this transaction was among entities under common control, we recorded the acquired assets at Holly s historic book value of $6.8 million. The $71.9 million excess of the purchase price over the historic book value is recorded as a reduction to partners equity for financial accounting purposes.

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 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 is being built to 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. This investment is expected to take the place of a project that we had been considering to construct and operate a new pipeline called the Porcupine Ridge Pipeline to transport crude oil from the Utah terminus of the Frontier Pipeline to Salt Lake City.

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 four-year $100 million senior secured revolving credit agreement (the Credit Agreement).

The HLS board of directors is also considering a project to construct a 12-inch pipeline from Salt Lake City to Las Vegas, with service also to the Cedar City, Utah area. The initial capacity of the pipeline would be approximately 62,000 bpd, and it is expected that the capacity could be later increased up to approximately 118,000 bpd by adding pump stations. The cost of the pipeline is expected to be approximately $235 million, and the total cost of the project including terminals is expected to be approximately $300 million. We are currently in the process of soliciting potential shippers for binding commitments through an open season extending to the latter part of March 2007, and we expect to make a final decision on whether to proceed with this project based on the level of commitment from shippers. Certain preliminary work has already been carried out on this project by Holly, but as of the date of this report we have not expended HEP funds or committed to do so with respect to the project. If we choose to carry out this project, our financing for the project would include reimbursement to Holly for previous expenditures and assumption of any commitments previously made by Holly with respect to the project, and might also involve an investment in the project by one or more other companies, making our investment proportionately less.

We expect to use the issuance of common units and/or debt securities 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.

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SAFETY AND MAINTENANCE

We perform preventive and normal maintenance on all of our pipeline systems and make repairs and replacements when necessary or appropriate. We also conduct routine and required inspections of our pipelines and other assets as required by code or regulation. We inject corrosion inhibitors into our mainlines to help control internal corrosion. External coatings and impressed current cathodic protection systems are used to protect against external corrosion. We conduct all cathodic protection work in accordance with National Association of Corrosion Engineers standards. We regularly monitor, test and record the effectiveness of these corrosion-inhibiting systems.

We monitor the structural integrity of selected segments of our pipeline systems through a program of periodic internal inspections using both dent pigs and electronic smart pigs , as well as hydrostatic testing that conforms to federal standards. We follow these inspections with a review of the data and we make repairs as necessary to ensure the integrity of the pipeline. We have initiated a risk-based approach to prioritizing the pipeline segments for future smart pig runs or other approved integrity testing methods. We believe this approach will ensure that the pipelines that have the greatest risk potential receive the highest priority in being scheduled for inspections or pressure tests for integrity.

We started our smart pigging program in 1988, prior to Department of Transportation (DOT) regulations requiring the program. Beginning in 2002, the DOT required smart pigging or other integrity testing of all DOT-regulated crude oil and refined product pipelines. This requirement is being phased in over a five-year period. As of December 31, 2006 we were in compliance with DOT requirements.

Maintenance facilities containing equipment for pipe repairs, spare parts, and trained response personnel are located along the pipelines. Employees participate in simulated spill deployment exercises on a regular basis. They also participate in actual spill response boom deployment exercises in planned spill scenarios in accordance with Oil Pollution Act of 1990 requirements. We believe that all of our pipelines have been constructed and are maintained in all material respects in accordance with applicable federal, state, and local laws and the regulations and standards prescribed by the American Petroleum Institute, the DOT, and accepted industry practice.

At our terminals, tanks designed for gasoline storage are equipped with internal or external floating roofs that minimize emissions and prevent potentially flammable vapor accumulation between fluid levels and the roof of the tank. Our terminal facilities have facility response plans, spill prevention and control plans, and other plans and programs to respond to emergencies.

Many of our terminal loading racks are protected with water deluge systems activated by either heat sensors or an emergency switch. Several of our terminals are also protected by foam systems that are activated in case of fire. All of our terminals are subject to participation in a comprehensive environmental management program to assure compliance with applicable air, solid waste, and wastewater regulations.

COMPETITION

As a result of our physical integration with Holly s Navajo Refinery and our contractual relationship with Holly under the Omnibus Agreement and the two Holly pipelines and terminals agreements, we believe that we will not face significant competition for barrels of refined products transported from Holly s Navajo Refinery, particularly during the term of our Holly PTA and Holly IPA expiring in 2019 and 2020, respectively. Additionally, with our contractual relationship with Alon under the Alon PTA, we believe that we will not face significant competition for those barrels of refined products we transport from Alon s Big Spring Refinery, particularly during the term of our Alon PTA expiring in 2020.

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We do, however, face competition from other pipelines that may be able to supply the end-user markets of Holly or Alon with refined products on a more competitive basis. Additionally, If Holly s wholesale customers reduced their purchases of refined products due to the increased availability of cheaper product from other suppliers or for other reasons, the volumes transported through our pipelines could be reduced, which, subject to the minimum revenue commitments, could cause a decrease in cash and revenues generated from our operations.

The petroleum refining business is highly competitive. Among Holly s competitors are some of the world s largest integrated petroleum companies, which have their own crude oil supplies and distribution and marketing systems. Holly competes with independent refiners as well. Competition in particular geographic areas is affected primarily by the amounts of refined products produced by refineries located in such areas and by the availability of refined products and the cost of transportation to such areas from refineries located outside those areas.

In addition, we face competition from trucks that deliver product in a number of areas we serve. While their costs may not be competitive for longer hauls or large volume shipments, trucks compete effectively for incremental and marginal volumes in many areas we serve. The availability of truck transportation places some competitive constraints on us.

Historically, the significant majority of the throughput at our terminal facilities has come from Holly, with the exception of third-party receipts at the Spokane terminal, Alon volumes at El Paso, and the Abilene and Wichita Falls terminals acquired from Alon that serve Alon s Big Springs Refinery. Under the terms of the Holly PTA, we continue to receive a significant portion of the throughput at our terminal facilities from Holly.

Our eleven refined product terminals compete with other independent terminal operators as well as integrated oil companies on the basis of terminal location, price, versatility and services provided. Our competition primarily comes from integrated petroleum companies, refining and marketing companies, independent terminal companies and distribution companies with marketing and trading arms.

RATE REGULATION

Some of our existing pipelines are subject to rate regulation by the Federal Energy Regulatory Commission (the FERC) under the Interstate Commerce Act. The Interstate Commerce Act requires that tariff rates for oil pipelines, a category that includes crude oil and petroleum product pipelines, be just and reasonable and non-discriminatory. The Interstate Commerce Act permits challenges to proposed new or changed rates by protest, and challenges to rates that are already on file and in effect by complaint. Upon the appropriate showing, a successful complainant may obtain damages or reparations for generally up to two years prior to the filing of a complaint. The FERC generally has not investigated interstate rates on its own initiative when those rates, like ours, have not been the subject of a protest or a complaint by a shipper. However, the FERC could investigate any new interstate rates we might file if those rates were protested by a third party and the third party were able to show that it had a substantial economic interest in our tariff rate level. The FERC could also investigate any of our existing interstate rates if a complaint were filed against the rate.

While the FERC regulates the rates for interstate shipments on our refined product pipelines, the New Mexico Public Regulation Commission regulates the rates for intrastate shipments in New Mexico, the Texas Railroad Commission regulates the rates for intrastate shipments in Texas, and the Idaho Public Utilities Commission regulates the rates for intrastate shipments in Idaho. State commissions have generally not been aggressive in regulating common carrier pipelines and have generally not investigated the rates or practices of petroleum pipelines in the absence of shipper complaints, and we do not believe the intrastate tariffs now in effect are likely to be challenged. A state regulatory commission could, however, investigate our rates if such a challenge were filed.

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ENVIRONMENTAL REGULATION AND REMEDIATION

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 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. When the Intermediate Pipelines were purchased in July 2005, Holly agreed to provide $2.5 million of additional indemnification, bringing the total indemnification provided to us from Holly to $17.5 million. Of this total, indemnification above $15.0 million relates solely to the Intermediate Pipelines. 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, under which Alon, for a ten year term expiring in 2015, will indemnify us subject to a $100,000 deductible and a $20.0 million maximum liability cap.

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, since such releases would be covered under environmental indemnification agreements.

An environmental remediation project is in progress currently at our El Paso terminal, the remaining costs of which are projected to be approximately $1.2 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 December 31, 2006, 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. At December 31, 2006, we estimate the remaining cost on this project to be $0.2 million, half of which 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 three remediation projects mentioned above, including assessment, monitoring, and remediation programs.

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In the fourth quarter of 2005, we experienced a refined product release in Jones County, Texas on one of the pipelines recently acquired from Alon. As of December 31, 2006, we estimate that the total remaining remediation cost for this incident to be insignificant. We also experienced a refined product release near Sweetwater, Texas for which we expect to incur remediation costs of $0.1 million in 2007. Neither of these occurrences is 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.

EMPLOYEES

To carry out our operations, HLS employs 89 people who provide direct support to our operations. None of these employees is covered by collective bargaining agreements. Holly Logistic Services, L.L.C. considers its employee relations to be good. Neither we nor our general partner have employees. We reimburse Holly for direct expenses Holly incurs on our behalf for the employees of HLS.

Item 1A. Risk Factors

Investing in us involves a degree of risk, including the risks described below. You should carefully consider the following risk factors together with all of the other information included in this Annual Report on Form 10-K, including the financial statements and related notes, when deciding to invest in us. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial may also materially and adversely affect our business operations. If any of the following risks were to actually occur, our business, financial condition or results of operations could be materially and adversely affected.

We depend upon Holly and particularly its Navajo Refinery for a majority of our revenues; and if those revenues were reduced or if Holly s financial condition materially deteriorated, there would be a material adverse effect on our results of operations.

For the year ended December 31, 2006, Holly accounted for 57% of the revenues of our petroleum products pipelines and 69% of the revenues of our terminals and truck loading racks. We expect to continue to derive a majority of our revenues from Holly for the foreseeable future. If Holly satisfies only its minimum obligations under the Holly PTA and Holly IPA or is unable to meet its minimum revenue commitment for any reason, including due to prolonged downtime or a shutdown at the Navajo Refinery or the Woods Cross Refinery, our revenues would decline.

Any significant curtailing of production at the Navajo Refinery could, by reducing throughput in our pipelines and terminals, result in our realizing materially lower levels of revenues and cash flow for the duration of the shutdown. For the year ended December 31, 2006, production from the Navajo Refinery accounted for 53% of the throughput volumes transported by our refined product pipelines. The Navajo Refinery also received 100% of the petroleum products shipped on our Intermediate Pipelines. Operations at the Navajo Refinery could be partially or completely shut down, temporarily or permanently, as the result of:

- competition from other refineries and pipelines that may be able to supply the refinery s end-user markets on a more cost-effective basis;

- operational problems such as catastrophic events at the refinery, labor difficulties or environmental proceedings or other litigation that compel the cessation of all or a portion of the operations at the refinery;

- planned maintenance or capital projects;

increasingly stringent environmental laws and regulations, such as the Environmental Protection Agency s gasoline and diesel sulfur control requirements that limit the concentration of sulfur in motor gasoline and diesel fuel for both on-road and non-road usage as well as various state and federal emission requirements that may affect the refinery itself;

an inability to obtain crude oil for the refinery at competitive prices; or

a general reduction in demand for refined products in the area due to:

a local or national recession or other adverse economic condition that results in lower spending by businesses and consumers on gasoline and diesel fuel;

higher gasoline prices due to higher crude oil prices, higher taxes or stricter environmental laws or regulations; or

a shift by consumers to more fuel-efficient or alternative fuel vehicles or an increase in fuel economy, whether as a result of technological advances by manufacturers, legislation either mandating or encouraging higher fuel economy or the use of alternative fuel or otherwise.

The magnitude of the effect on us of any shutdown would depend on the length of the shutdown and the extent of the refinery operations affected by the shutdown. We have no control over the factors that may lead to a shutdown or the measures Holly may take in response to a shutdown. Holly makes all decisions at the Navajo Refinery concerning levels of production, regulatory compliance, refinery turnarounds (planned shutdowns of individual process units within the refinery to perform major maintenance activities), labor relations, environmental remediation and capital expenditures; is responsible for all related costs; and is under no contractual obligation to us to maintain operations at the Navajo Refinery.

Furthermore, Holly s obligations under the Holly PTA and Holly IPA would be temporarily suspended during the occurrence of a *force majeure* that renders performance impossible with respect to an asset for at least 30 days. If such an event were to continue for a year, we or Holly could terminate the agreements. The occurrence of any of these events could reduce our revenues and cash flows.

We depend on Alon and particularly its Big Spring Refinery for a substantial portion of our revenues; and if those revenues were significantly reduced, there would be a material adverse effect on our results of operations.

For the year ended December 31, 2006, Alon accounted for 28% of the combined revenues of our petroleum products pipelines and of our terminals and truck loading racks, including revenues we received from Alon under a capacity lease agreement.

A decline in production at Alon s Big Spring Refinery would materially reduce the volume of refined products we transport and terminal for Alon. As a result, our revenues would be materially adversely affected. The Big Spring Refinery could partially or completely shut down its operations, temporarily or permanently, due to factors affecting its ability to produce refined products or for planned maintenance or capital projects. Such factors would include the factors discussed above under the discussion of risk factors for the Navajo Refinery.

The magnitude of the effect on us of any shutdown would depend on the length of the shutdown and the extent of the refinery operations affected. We have no control over the factors that may lead to a shutdown or the measures Alon may take in response to a shutdown. Alon makes all decisions and is responsible for all costs at the Big Spring Refinery concerning levels of production, regulatory compliance, refinery turnarounds, labor relations, environmental remediation and capital expenditures.

In addition, under the Alon PTA, if we are unable to transport or terminal refined products that Alon is prepared to ship, then Alon has the right to reduce its minimum volume commitment to us during the period of interruption. If a *force majeure* event occurs beyond the control of either of us, we or Alon could terminate the Alon pipelines and terminals agreement after the expiration of certain time periods. The occurrence of any of these events could reduce our revenues and cash flows.

We are exposed to the credit risks of our key customers.

We are subject to risks of loss resulting from nonpayment or nonperformance by our customers. As stated above, we receive substantial revenues from both Holly and Alon under their respective pipelines and terminals agreements. In addition, a subsidiary of BP Plc (BP) is the only shipper on the Rio Grande Pipeline, a joint venture in which we own a 70% interest and from which we derived 9% of our revenues for the year ended December 31, 2006.

If any of our key customers default on their obligations to us, our financial results could be adversely affected. Furthermore, some of our customers may be highly leveraged and subject to their own operating and regulatory risks.

Competition from other pipelines that may be able to supply our shippers customers with refined products at a lower price could cause us to reduce our rates or could reduce our revenues.

We and our shippers could face increased competition if other pipelines are able to competitively supply our shippers end-user markets with refined products. The Longhorn Pipeline is a common carrier pipeline that is capable of delivering refined products utilizing a direct route from the Texas Gulf Coast to El Paso and, through interconnections with third-party common carrier pipelines, into the Arizona market. Since inception of Longhorn Pipeline operations in late 2005, little impact has been seen on the operations of Holly, Alon, or HEP. However, if the Longhorn Pipeline is ever able to operate as has been proposed and significantly increases the volumes of refined products it transports, it could result in downward pressure on wholesale refined product prices and refined product margins in El Paso and related markets. Additionally, an increased supply of refined products from Gulf Coast refiners entering the El Paso and Arizona markets on this pipeline and a resulting increase in the demand for shipping product on the interconnecting common carrier pipelines, which are currently capacity constrained, could cause a decline in the demand for refined product from Holly or Alon. For Holly, this eventuality could ultimately result in a reduction in Holly s minimum revenue commitment to us under the Holly PTA and Holly IPA; and while our pipelines and terminals agreement with Alon does not provide for a reduction in Alon s minimum volume commitment obligation in these circumstances, such eventuality could reduce our opportunity to earn revenue from Alon in excess of Alon s minimum volume commitment obligation.

An additional factor that could affect some of Holly s and Alon s markets is excess pipeline capacity from the West Coast into our shippers Arizona markets on the pipeline from the West Coast to Phoenix. If refined products become available on the West Coast in excess of demand in that market, additional products could be shipped into our shippers Arizona markets with resulting possible downward pressure on refined product prices that, if sustained over the long term, could influence product shipments by Holly and Alon to these markets.

A material decrease in the supply, or a material increase in the price, of crude oil available to Holly s and Alon s refineries, could materially reduce our revenues.

The volume of refined products we transport in our refined products pipelines depends on the level of production of refined products from Holly s and Alon s refineries, which, in turn, depends on the availability of attractively-priced crude oil produced in the areas accessible to those refineries. In order to maintain or increase production levels at their refineries, our shippers must continually contract for new crude oil supplies. A material decrease in crude oil production from the fields that supply their refineries, as a result of depressed commodity prices, lack of drilling activity, natural production declines or otherwise, could result in a decline in the volume of crude oil our shippers refine, absent the availability of transported crude oil to offset such declines. Such an event would result in an overall decline in volumes of refined products transported through our pipelines and therefore a corresponding reduction in our cash flow. In addition, the future growth of our shippers operations will depend in part upon whether our shippers can contract for additional supplies of crude oil at a greater rate than the rate of natural decline in their currently connected supplies.

Fluctuations in crude oil prices can greatly affect production rates and investments by third parties in the development of new oil reserves. Drilling activity generally decreases as crude oil prices decrease. We and our shippers have no control over the level of drilling activity in the areas of operations, the amount of reserves underlying the wells and the rate at which production from a well will decline, or producers or their production decisions, which are affected by, among other things, prevailing and projected energy prices, demand for hydrocarbons, geological considerations, governmental regulation and the availability and cost of capital. Similarly, a material increase in the price of crude oil supplied to our shippers refineries without an increase in the value of the products produced by the refineries, either temporary or permanent, which caused a reduction in the production of refined products at the refineries, would cause a reduction in the volumes of refined products we transport, and our cash flow could be adversely affected.

We may not be able to retain existing customers or acquire new customers.

The renewal or replacement of existing contracts with our customers at rates sufficient to maintain current revenues and cash flows depends on a number of factors outside our control, including competition from other pipelines and the demand for refined products in the markets that we serve. Alon s obligations to lease capacity on the Artesia-Orla-El Paso pipeline have remaining terms ranging from one and one-half to three and one-half years. BP s agreement to ship on the Rio Grande Pipeline expires in July 2007 and will continue year-to-year thereafter unless cancelled by either party. Our pipelines and terminals agreements with Holly and Alon expire in 2019 and 2020.

Our operations are subject to federal, state, and local laws and regulations relating to environmental protection and operational safety that could require us to make substantial expenditures.

Our pipelines and terminal operations are subject to increasingly strict environmental and safety laws and regulations. The transportation and storage of refined products produces a risk that refined products and other hydrocarbons may be suddenly or gradually released into the environment, potentially causing substantial expenditures for a response action, significant government penalties, liability to government agencies for natural resources damages, personal injury or property damages to private parties and significant business interruption. We own or lease a number of properties that have been used to store or distribute refined products for many years. Many of these properties have also been operated by third parties whose handling, disposal, or release of hydrocarbons and other wastes were not under our control. If we were to incur a significant liability pursuant to environmental laws or regulations, it could have a material adverse effect on us.

Our operations are subject to operational hazards and unforeseen interruptions for which we may not be adequately insured.

Our operations are subject to operational hazards and unforeseen interruptions such as natural disasters, adverse weather, accidents, fires, explosions, hazardous materials releases, mechanical failures and other events beyond our control. These events might result in a loss of equipment or life, injury, or extensive property damage, as well as an interruption in our operations. We may not be able to maintain or obtain insurance of the type and amount we desire at reasonable rates. As a result of market conditions, premiums and deductibles for certain of our insurance policies have increased, and could escalate further. In some instances, certain insurance could become unavailable or available only for reduced amounts of coverage. If we were to incur a significant liability for which we were not fully insured, it could have a material adverse effect on our financial position.

Any reduction in the capacity of, or the allocations to, our shippers in interconnecting, third-party pipelines could cause a reduction of volumes transported in our pipelines and through our terminals.

Holly, Alon and the other users of our pipelines and terminals are dependent upon connections to third-party pipelines to receive and deliver crude oil and refined products. Any reduction of capacities of these

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interconnecting pipelines due to testing, line repair, reduced operating pressures, or other causes could result in reduced volumes transported in our pipelines or through our terminals. Similarly, if additional shippers begin transporting volumes of refined products over interconnecting pipelines, the allocations to existing shippers in these pipelines would be reduced, which could also reduce volumes transported in our pipelines or through our terminals. For example, the common carrier pipelines used by Holly to serve the Arizona and Albuquerque markets are currently operated at or near capacity and are subject to proration. As a result, the volumes of refined product that Holly and other shippers have been able to deliver to these markets have been limited. The flow of additional products into El Paso for shipment to Arizona could further exacerbate such constraints on deliveries to Arizona. Any reduction in volumes transported in our pipelines or through our terminals could adversely affect our revenues and cash flows.

If our assumptions concerning population growth are inaccurate or if Holly s growth strategy is not successful, our ability to grow may be adversely affected.

Our growth strategy is dependent upon:

- the accuracy of our assumption that many of the markets that we serve in the Southwestern and Rocky Mountain regions of the United States will experience population growth that is higher than the national average; and

- the willingness and ability of Holly to capture a share of this additional demand in its existing markets and to identify and penetrate new markets in the Southwestern and Rocky Mountain regions of the United States.

If our assumptions about growth in market demand prove incorrect, Holly may not have any incentive to increase refinery capacity and production or shift additional throughput to our pipelines, which would adversely affect our growth strategy. Furthermore, Holly is under no obligation to pursue a growth strategy. If Holly chooses not to, or is unable to, gain additional customers in new or existing markets in the Southwestern and Rocky Mountain regions of the United States, our growth strategy would be adversely affected. Moreover, Holly may not make acquisitions that would provide acquisition opportunities to us; or, if those opportunities arise, they may not be on terms attractive to us. Finally, Holly also will be subject to integration risks with respect to any new acquisitions it chooses to make.

Growing our business by constructing new pipelines and terminals, or expanding existing ones, subjects us to construction risks.

One of the ways we may grow our business is through the construction of new pipelines and terminals or the expansion of existing ones. The construction of a new pipeline or the expansion of an existing pipeline, by adding horsepower or pump stations or by adding a second pipeline along an existing pipeline, involves numerous regulatory, environmental, political, and legal uncertainties, most of which are beyond our control. These projects may not be completed on schedule or at all or at the budgeted cost. In addition, our revenues may not increase immediately upon the expenditure of funds on a particular project. For instance, if we build a new pipeline, the construction will occur over an extended period of time and we will not receive any material increases in revenues until after completion of the project. Moreover, we may construct facilities to capture anticipated future growth in demand for refined products in a region in which such growth does not materialize. As a result, new facilities may not be able to attract enough throughput to achieve our expected investment return, which could adversely affect our results of operations and financial condition.

Rate regulation may not allow us to recover the full amount of increases in our costs.

The primary rate-making methodology of the FERC is price indexing. We use this methodology in all of our interstate markets. The indexing method allows a pipeline to increase its rates based on a percentage change in the producer price index for finished goods. If the index falls, we will be required to reduce our rates that are based on the FERC s price indexing methodology if they exceed the new maximum allowable rate. In addition, changes in the index might not be large enough to fully reflect actual increases in our costs. The FERC s rate-making methodologies may limit our ability to set rates

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based on our true costs or may delay the use of rates that reflect increased costs. Any of the foregoing would adversely affect our revenues and cash flow.

If our interstate or intrastate tariff rates are successfully challenged, we could be required to reduce our tariff rates, which would reduce our revenues.

Under the FERC indexing methodology, 18 CRF 342-3, our interstate pipeline tariff rates are deemed just and reasonable. If a party with an economic interest were to file either a protest or a complaint against our tariff rates, then our existing rates could be subject to detailed review. If our rates were found to be in excess of levels justified by our cost of service, the FERC could order us to reduce our rates. In addition, a state commission could also investigate our intrastate rates or our terms and conditions of service on its own initiative or at the urging of a shipper or other interested party. If a state commission found that our rates exceeded levels justified by our cost of service, the state commission could order us to reduce our rates. Any such reductions would result in lower revenues and cash flows.

Holly and Alon have agreed not to challenge, or to cause others to challenge or assist others in challenging, our tariff rates in effect during the terms of their respective pipelines and terminals agreements. These agreements do not prevent other current or future shippers from challenging our tariff rates.

Potential changes to current petroleum pipeline rate-making methods and procedures may impact the federal and state regulations under which we will operate in the future.

If the FERC s petroleum pipeline rate-making methodology changes, the new methodology could result in tariffs that generate lower revenues and cash flow.

Terrorist attacks, and the threat of terrorist attacks, have resulted in increased costs to our business. Continued hostilities in the Middle East or other sustained military campaigns may adversely impact our results of operations.

The long-term impact of terrorist attacks, such as the attacks that occurred on September 11, 2001, and the threat of future terrorist attacks, on the energy transportation industry in general, and on us in particular, is not known at this time. Increased security measures taken by us as a precaution against possible terrorist attacks have resulted in increased costs to our business. Uncertainty surrounding continued hostilities in the Middle East or other sustained military campaigns may affect our operations in unpredictable ways, including disruptions of crude oil supplies and markets for refined products, and the possibility that infrastructure facilities could be direct targets of, or indirect casualties of, an act of terror.

Changes in the insurance markets attributable to terrorist attacks may make certain types of insurance more difficult for us to obtain. Moreover, the insurance that may be available to us may be significantly more expensive than our existing insurance coverage. Instability in the financial markets as a result of terrorism or war could also affect our ability to raise capital including our ability to repay or refinance debt.

Our leverage may limit our ability to borrow additional funds, comply with the terms of our indebtedness or capitalize on business opportunities.

As of December 31, 2006, the principal amount of our total outstanding long-term debt was $185.0 million. Various limitations in our Credit Agreement and the indenture for our Senior Notes may reduce our ability to incur additional debt, to engage in some transactions and to capitalize on business opportunities. Any subsequent refinancing of our current indebtedness or any new indebtedness could have similar or greater restrictions.

Our leverage could have important consequences. We will require substantial cash flow to meet our payment obligations with respect to our indebtedness. Our ability to make scheduled payments, to refinance our obligations with respect to our indebtedness or our ability to obtain additional financing in the future will depend on our financial and operating performance, which, in turn, is subject to prevailing economic conditions and to financial, business and other factors. We believe that we will have sufficient cash flow from operations and available borrowings under our Credit Agreement to service our indebtedness. However, a significant downturn in our business or other development adversely affecting our cash flow could materially impair our ability to service our indebtedness. If our cash flow and capital resources are insufficient to fund our debt service obligations, we may be forced to refinance all or a portion of our debt or sell assets. We cannot assure you that we would be able to refinance our existing indebtedness or sell assets on terms that are commercially reasonable.

The instruments governing our debt contain restrictive covenants that may prevent us from engaging in certain beneficial transactions. The agreements governing our debt generally require us to comply with various affirmative and negative covenants including the maintenance of certain financial ratios and restrictions on incurring additional debt, entering into mergers, consolidations and sales of assets, making investments and granting liens. Additionally, our contribution agreement with Alon restricts us from selling the pipelines and terminals acquired from Alon and from prepaying more than $30.0 million of the Senior Notes until 2015, subject to certain limited exceptions. Our leverage may adversely affect our ability to fund future working capital, capital expenditures and other general partnership requirements, future acquisition, construction or development activities, or to otherwise fully realize the value of our assets and opportunities because of the need to dedicate a substantial portion of our cash flow from operations to payments on our indebtedness or to comply with any restrictive terms of our indebtedness. Our leverage may also make our results of operations more susceptible to adverse economic and industry conditions by limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate and may place us at a competitive disadvantage as compared to our competitors that have less debt.

Our growth through acquisitions may be limited by future market considerations.

Future business or asset acquisitions may be dependent upon financial market conditions. Increases in our average cost of capital resulting from increases in interest rates or changes in our bond rating or from increased cost of equity capital may prevent us from making accretive acquisitions and thus limit our growth opportunities.

Item 1B. Unresolved Staff Comments

We do not have any unresolved SEC staff comments.

Item 2. Properties

PIPELINES

Our refined product pipelines transport light refined products from Holly s Navajo Refinery in New Mexico and Alon s Big Spring Refinery in Texas to their customers in the metropolitan and rural areas of Texas, New Mexico, Oklahoma, Arizona, Colorado, Utah and northern Mexico. The refined products transported in these pipelines include conventional gasolines, federal, state and local specification reformulated gasoline, low-octane gasoline for oxygenate blending, distillates that include high- and low-sulfur diesel and jet fuel and LPGs (such as propane, butane and isobutane).

Our intermediate product pipelines consist of two parallel pipelines that originate at Holly s Lovington, New Mexico refining facilities and terminate at Holly s Artesia, New Mexico refining facilities. These pipelines transport intermediate feedstocks and crude oil for Holly s refining operations in New Mexico.

Our pipelines are regularly inspected and are well maintained, and we believe they are in good repair. Generally, other than as provided in the pipelines and terminal agreements with Holly and Alon, all of our pipelines are unrestricted as to the direction in which product flows and the types of refined products that we can transport on them. The FERC regulates the transportation tariffs for interstate shipments on our refined product pipelines and state regulatory agencies regulate the transportation tariffs for intrastate shipments on our pipelines.

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The following table details the average aggregate daily number of barrels of petroleum products transported on our pipelines in each of the periods set forth below for Holly and for third parties.

	Years Ended December 31,				
	2006	2005(1)	2004	2003	2002
Refined products transported for (bpd):					
Holly	126,929	94,473	65,525	51,456	55,288
Third parties (2)	62,655	65,053	29,967	23,469	13,553
Total	189,584	159,526	95,492	74,925	68,841
Total annual barrels in thousands (mbbls)	69,198	58,227	34,950	27,348	25,127

(1) Includes volumes transported on the pipelines acquired from Alon on February 28, 2005, and volumes transported on the Intermediate Pipelines acquired on July 8, 2005.

(2) Includes Rio Grande Pipeline volumes beginning June 30, 2003, when we increased our ownership from 25% to 70% and began consolidating the results of Rio Grande Pipeline.

The following table sets forth certain operating data for each of our petroleum product pipelines. Except as shown below, we own 100% of our refined product pipelines. Throughput is the total average number of barrels per day transported on a pipeline, but does not aggregate barrels moved between different points on the same pipeline.

Revenues reflect tariff revenues generated by barrels shipped from an origin to a delivery point on a pipeline. Revenues also include payments made by Alon under capacity lease arrangements on our Orla to El Paso pipeline. Under these arrangements, we provide space on our pipeline for the shipment of up to 20,000 barrels of refined product per day. Alon pays us whether or not it actually ships the full volumes of refined products it is entitled to ship. To the extent Alon does not use its capacity, we are entitled to use it. We calculate the capacity of our pipelines based on the throughput capacity for barrels of gasoline equivalent that may be transported in the existing configuration; in some cases, this includes the use of drag reducing agents.

Origin and Destination	Diameter (inches)	Approximate Length (miles)	Capacity (bpd)
Refined Product Pipelines:			
Artesia, NM to El Paso, TX	6	156	24,000
Artesia, NM to Orla, TX to El Paso, TX	8/12/8	215	70,000(1)
Artesia, NM to Moriarty, NM(2)	12/8	215	45,000(3)
Moriarty, NM to Bloomfield, NM(2)	8	191	(3)
Big Spring, TX to Abilene, TX(4)	6/8	105	20,000
Big Spring, TX to Wichita Falls, TX(4)	6/8	227	23,000
Wichita Falls, TX to Duncan, OK(4)	6	47	21,000
Midland, TX to Orla, TX(4)	8/10	135	25,000
Intermediate Product Pipelines:			
Lovington, NM to Artesia, NM(5)	8	65	48,000
Lovington, NM to Artesia, NM(5)	10	65	72,000
Rio Grande Pipeline Company:			
Rio Grande Pipeline(6)	8	249	27,000

(1) *Includes 20,000 bpd of capacity on the Orla to El Paso segment of this pipeline that is leased to Alon under capacity lease agreements.*

(2) *The White Lakes Junction to Moriarty segment of our Artesia to Moriarty pipeline and our Moriarty to Bloomfield pipeline is leased from Mid-America Pipeline Company, LLC*

under a long-term lease agreement.

(3) *Capacity for this pipeline is reflected in the information for the Artesia to Moriarty pipeline.*

(4) *Acquired from Alon on February 28, 2005.*

(5) *Acquired from Holly on July 8, 2005.*

(6) *We have a 70% joint venture interest in the entity that owns this pipeline. Capacity reflects a 100% interest. We increased our ownership interest in Rio Grande Pipeline Company from 25% to 70% on June 30, 2003.*

For the years ended December 31, 2006 and 2005, Holly shipped an aggregate of 52.6% and 50.4%, respectively, of the petroleum products transported on our refined product pipelines and 100% of the petroleum products transported on our Intermediate Pipelines. For the same periods, these pipelines transported approximately 95% of the light refined products produced by Holly s Navajo Refinery.

Artesia, New Mexico to El Paso, Texas

The Artesia to El Paso refined product pipeline is regulated by the FERC. It was constructed in 1959 and consists of 156 miles of 6-inch pipeline. This pipeline is used for the shipment of refined products produced at Holly s Navajo Refinery to our El Paso terminal, where we deliver to common carrier pipelines for transportation to Arizona, northern New Mexico and northern Mexico and to the terminal s truck rack for local delivery by tanker truck. Holly is the only shipper on this pipeline. The refined products shipped on this pipeline represented 20% of the total light refined products produced at Holly s Navajo Refinery during 2006. Refined products produced at Holly s Navajo Refinery destined for El Paso are transported on either this pipeline or our Artesia to Orla to El Paso pipeline.

Artesia, New Mexico to Orla, Texas to El Paso, Texas

The Artesia to Orla to El Paso refined product pipeline is a common-carrier pipeline regulated by the FERC and consists of three segments:

- an 8-inch, 67-mile and a 12-inch, 14-mile segment from the Navajo Refinery to Orla, Texas, constructed in 1981;
- a 12-inch, 99-mile segment from Orla to outside El Paso, Texas, constructed in 1996; and
- an 8-inch, 35-mile segment from outside El Paso to our El Paso terminal, constructed in the mid 1950 s

There are two shippers on this pipeline, Holly and Alon. In 2006, this pipeline transported to our El Paso terminal 49% of the light refined products produced at Holly s Navajo Refinery. As mentioned above, refined products destined to the El Paso terminal are delivered to common carrier pipelines for transportation to Arizona, northern New Mexico and northern Mexico and to the terminal s truck rack for local delivery by tanker truck.

At Orla, the pipeline received volumes of gasoline and diesel from Alon s Big Spring, Texas refinery through a tie-in to an Alon pipeline system.

Artesia, New Mexico to Moriarty, New Mexico

The Artesia to Moriarty refined product pipeline consists of a 60-mile, 12-inch pipeline from Holly s Artesia facility to White Lakes Junction, New Mexico that was constructed in 1999, and approximately 155 miles of 8-inch pipeline that was constructed in 1973 and extends from White Lakes Junction to our Moriarty terminal, where it also connects to our Moriarty to Bloomfield pipeline. We own the 12-inch pipeline from Artesia to White Lakes Junction. We lease the White Lakes Junction to Moriarty segment of this pipeline and our Moriarty to Bloomfield pipeline described below, from Mid-America Pipeline Company, LLC under a long-term lease agreement entered into in 1996, which expires in 2017 and has two ten-year extensions at our option. At our Moriarty terminal, volumes shipped on this pipeline can be transported to other markets in the area, including Albuquerque, Santa Fe and west Texas, via tanker truck. The 155-mile White Lakes Junction to Moriarty segment of this pipeline is operated by Mid-America Pipeline Company, LLC (or its designee). Holly is the only shipper on this pipeline. We currently pay a monthly fee (which is subject to adjustments based on changes in the PPI) of $487,000 to Mid-America Pipeline Company, LLC to lease the White Lakes Junction to Moriarty and Moriarty to Bloomfield pipelines.

Moriarty, New Mexico to Bloomfield, New Mexico

The Moriarty to Bloomfield refined product pipeline was constructed in 1973 and consists of 191 miles of 8-inch pipeline leased from Mid-America Pipeline Company, LLC. This pipeline serves our terminal in Bloomfield. At our Bloomfield terminal, volumes shipped on this pipeline are transported to other markets in the Four Corners area via tanker truck. This pipeline is operated by Mid-America Pipeline Company, LLC (or its designee). Holly is the only shipper on this pipeline.

Big Spring, Texas to Abilene, Texas

The Big Spring to Abilene refined product pipeline was constructed in 1957 and consists of 100 miles of 6-inch pipeline and 5 miles of 8-inch pipeline. This pipeline is used for the shipment of refined products produced at Alon s Big Spring Refinery to the Abilene terminal. Alon is the only shipper on this pipeline.

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Big Spring, Texas to Wichita Falls, Texas

Segments of the Big Spring to Wichita Falls refined product pipeline were constructed in 1969 and 1989, and consist of 95 miles of 6-inch pipeline and 132 miles of 8-inch pipeline. This pipeline is used for the shipment of refined products produced at Alon s Big Spring Refinery to the Wichita Falls terminal. Alon is the only shipper on this pipeline.

Wichita Falls, Texas to Duncan, Oklahoma

The Wichita Falls to Duncan refined product pipeline is a common carrier and is regulated by the FERC. It was constructed in 1958 and consists of 47 miles of 6-inch pipeline. This pipeline is used for the shipment of refined products from the Wichita Falls terminal to Alon s Duncan terminal, which we do not own. Alon is the only shipper on this pipeline.

Midland, Texas to Orla, Texas

Segments of the Midland to Orla refined product pipeline were constructed in 1928 and 1998, and consist of 50 miles of 10-inch pipeline and 85 miles of 8-inch pipeline. This pipeline is used for the shipment of refined products produced at Alon s Big Spring Refinery from Midland, Texas to our tank farm at Orla, Texas. Alon is the only shipper on this pipeline.

8 Pipeline from Lovington, New Mexico to Artesia, New Mexico

The 65-mile 8-inch diameter pipeline was constructed in 1981. This pipeline is used for the shipment of intermediate feedstocks and crude oil from Holly s Lovington, New Mexico facility to Holly s Artesia, New Mexico facility. Holly is the only shipper on this pipeline.

10 Pipeline from Lovington, New Mexico to Artesia, New Mexico

The 65-mile 10-inch diameter pipeline was constructed in 1999. This pipeline is used for the shipment of intermediate feedstocks and crude oil from Holly s Lovington, New Mexico facility to Holly s Artesia, New Mexico facility. Holly is the only shipper on this pipeline.

Rio Grande Pipeline

We own a 70% interest in Rio Grande, a joint venture that owns a 249-mile, 8-inch common carrier LPG pipeline regulated by the FERC. The other owner of Rio Grande is a subsidiary of BP. The pipeline originates from a connection with an Enterprise pipeline in West Texas at Lawson Junction which serves as its primary receipt point, although there is an additional receipt point near Midland, Texas. The pipeline terminates at the Mexico border near San Elizario, Texas. The pipeline transports LPGs for ultimate use by Petróleos Mexicanos (PEMEX, the government-owned energy company of Mexico.) Rio Grande does not own any facilities or pipelines in Mexico. The pipeline has a current capacity of approximately 27,000 bpd. This pipeline was originally constructed in the mid 1950 s, was first reconditioned in 1988, and subsequently reconditioned in 1996 and 2003. Approximately 75 miles of this pipeline has been replaced with new pipe, and an additional 50 miles has been recoated.

Rio Grande was formed in 1996, at which time we contributed nearly 220 miles of pipeline from near Odessa, Texas to outside El Paso, Texas in exchange for a 25% interest in the joint venture. Rio Grande Pipeline began operations in 1997. In June 2003, we acquired an additional 45% interest in the joint venture from Juarez Pipeline Co., an affiliate of The Williams Companies, Inc., for $28.7 million. The pipeline has recently completed a reconditioning project that could facilitate an expansion to 32,000 bpd. Currently, only LPG s are transported on this pipeline, and BP is the only shipper. BP s contract provides that BP will ship a minimum average of 16,500 bpd for the duration of the agreement. This contract expires in July 2007, but will continue year-to-year thereafter unless cancelled by either party at the beginning of a contract year in which the contract was not cancelled. The tariff rates and shipping regulations are regulated by the FERC.

In January 2005, Rio Grande appointed us as operator of the pipeline system effective April 1, 2005 through January 31, 2010. We paid $745,000 to the then-current operator as an inducement to and consideration for its early resignation. As operator, we receive a management fee of $1.1 million per year, adjusted annually for any changes in the PPI.

An officer of HLS is one of the two members of Rio Grande s management committee.

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REFINED PRODUCT TERMINALS AND TRUCK RACKS

Our refined product terminals receive products from pipelines, Holly s Navajo and Woods Cross refineries and Alon s Big Spring Refinery. We then distribute them to Holly and third parties, who in turn deliver them to end-users and retail outlets. Our terminals are generally complementary to our pipeline assets and serve Holly s and Alon s marketing activities. Terminals play a key role in moving product to the end-user market by providing the following services:

- distribution;
- blending to achieve specified grades of gasoline;
- other ancillary services that include the injection of additives and filtering of jet fuel; and
- storage and inventory management.

Typically, our refined product terminal facilities consist of multiple storage tanks and are equipped with automated truck loading equipment that operates 24 hours a day. This automated system provides for control of security, allocations, and credit and carrier certification by remote input of data by our customers. In addition, nearly all of our terminals are equipped with truck loading racks capable of providing automated blending to individual customer specifications.

Our refined product terminals derive most of their revenues from terminalling fees paid by customers. We charge a fee for transferring refined products from the terminal to trucks or to pipelines connected to the terminal. In addition to terminalling fees, we generate revenues by charging our customers fees for blending, injecting additives, and filtering jet fuel. Holly currently accounts for the substantial majority of our refined product terminal revenues.

The table below sets forth the total average throughput for our refined product terminals in each of the periods presented:

	Years Ended December 31,				
	2006	**2005[1]**	**2004**	**2003**	**2002**
Refined products terminalled for (bpd):					
Holly	118,202	120,795	114,991	86,780	81,969
Third parties	43,285	42,334	24,821	19,956	12,374
Total	161,487	163,129	139,812	106,736	94,343
Total annual barrels in thousands (mbbls)	58,943	59,542	51,171	38,959	34,435

(1) Includes volumes for the terminals and tank farm acquired from Alon February 28, 2005.

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The following table outlines the locations of our terminals and their storage capacities, number of tanks, supply source, and mode of delivery:

Terminal Location	Storage Capacity (barrels)	Number of Tanks	Supply Source	Mode of Delivery
El Paso, TX	507,000	16	Pipeline/ rail	Truck/Pipeline
Moriarty, NM	189,000	9	Pipeline	Truck
Bloomfield, NM	193,000	7	Pipeline	Truck
Albuquerque, NM	64,000	9	Pipeline	Truck
Tucson, AZ(1)	176,000	9	Pipeline	Truck
Mountain Home, ID(2)	120,000	3	Pipeline	Pipeline
Boise, ID(3) (4)	111,000	9	Pipeline	Pipeline
Burley, ID(3)	70,000	7	Pipeline	Truck
Spokane, WA	333,000	32	Pipeline/Rail	Truck
Abilene, TX(5)	127,000	5	Pipeline	Truck/Pipeline
Wichita Falls, TX(5)	220,000	11	Pipeline	Truck/Pipeline
Orla tank farm(5)	135,000	5	Pipeline	Pipeline
Artesia facility truck rack	N/A	N/A	Refinery	Truck
Woods Cross facility truck rack	N/A	N/A	Refinery	Truck/Pipeline
Total	2,245,000			

(1) *The Tucson terminal consists of two parcels. On one parcel, we lease the underlying ground as a 50% co-tenant with a division of Valero, L.P. (* Valero *) pursuant to which we own 50% of the improvements on that parcel. On the other parcel, our joint venture with Valero leases the underlying ground and owns the improvements.*

This joint venture agreement gives us rights to 100% of the terminal capacity (for both parcels), which is operated by Valero for a fee.

(2) *Handles only jet fuel.*

(3) *We have a 50% ownership interest in these terminals. The capacity and throughput information represents the proportionate share of capacity and throughput attributable to our ownership interest.*

(4) *This terminal has seen limited use since its acquisition in June 2003.*

(5) *Acquired from Alon on February 28, 2005.*

El Paso Terminal

We receive light refined products at this terminal from Holly s Artesia facility through our Artesia to El Paso and Artesia to Orla to El Paso pipelines and by rail that account for approximately 83% of the volumes at this terminal. We also receive product from Alon s Big Spring, Texas refinery that accounted for 17% of the volumes at this terminal in 2006. Refined products received at this terminal are sold locally via the truck rack, transported to our Tucson terminal on Kinder Morgan Energy Partners L.P. s East System pipeline or to our Albuquerque terminal on the Juarez pipeline, which was acquired from Chevron by Plains Pipeline, L.P. in September 2006 (the Plains Pipeline). Competition in this market includes a refinery and terminal owned by Western Refining, a joint venture pipeline and terminal owned by ConocoPhillips and Valero, L.P. and a terminal connected to the Longhorn Pipeline.

Moriarty Terminal

We receive light refined products at this terminal from Holly s Artesia facility through our pipelines. Refined products received at this terminal are sold locally, via the truck rack; Holly is our only customer at this terminal. There are no competing terminals in Moriarty.

Bloomfield Terminal

We receive light refined products at this terminal from Holly s Artesia facility through our pipelines. Refined products received at this terminal are sold locally, via the truck rack; Holly is our only customer at this terminal. Competition in this market includes a refinery and terminal owned by Giant Industries.

Albuquerque Terminal

We receive light refined products from Holly that are transported on the Plains Pipeline from our El Paso terminal and account for over 90% of the volumes at this terminal. We also receive product from ConocoPhillips and Valero, L.P. that are transported to the Albuquerque terminal on Valero, L.P. s West Emerald pipeline from its McKee, Texas refinery. Refined products received at this terminal are sold locally, via the truck rack. Competition in the Albuquerque market includes terminals owned by Chevron, ConocoPhillips, Giant and Valero. We and ConocoPhillips each owned a 50% interest in the Albuquerque terminal through July 2004, at which time we acquired the 50% interest owned by ConocoPhillips.

Tucson Terminal

The Tucson terminal consists of two parcels. On one parcel, we lease the underlying ground as a 50% co-tenant with a division of Valero pursuant to which we own 50% of the improvements on that parcel. On the other parcel, our joint venture with Valero leases the underlying ground and owns the improvements. This joint venture agreement gives us rights to 100% of the terminal capacity (for both parcels), which is operated by Valero for a fee. We receive light refined products at this terminal from Kinder Morgan s East System pipeline, which transports refined products from Holly s Artesia facility that it receives at our El Paso terminal. Refined products received at this terminal are sold locally, via the truck rack. Competition in this market includes terminals owned by Kinder Morgan and CalJet.

Mountain Home Terminal

We receive jet fuel from third parties at this terminal that is transported on Chevron s Salt Lake City to Boise, Idaho pipeline. We then transport the jet fuel from the Mountain Home terminal through our 13-mile, 4-inch pipeline to the United States Air Force base outside of Mountain Home. Our pipeline associated with this terminal is the only pipeline that supplies jet fuel to the air base. We are paid a single fee, from the Defense Energy Support Center, for injecting, storing, testing and transporting jet fuel at this terminal.

Boise Terminal

We and Sinclair each own a 50% interest in the Boise terminal. Sinclair is the operator of the terminal. The Boise terminal receives light refined products from Holly and Sinclair shipped through Chevron s pipeline originating in Salt Lake City, Utah. The Woods Cross Refinery, as well as other refineries in the Salt Lake City area, and Pioneer s terminal in Salt Lake City are connected to the Chevron pipeline. All loading of products out of the Boise terminal is conducted at Chevron s loading rack, which is connected to the Boise terminal by pipeline. Holly and Sinclair are the only customers at this terminal.

Burley Terminal

We and Sinclair each own a 50% interest in the Burley terminal. Sinclair is the operator of the terminal. The Burley terminal receives product from Holly and Sinclair shipped through Chevron s pipeline originating in Salt Lake City, Utah. Refined products received at this terminal are sold locally, via the truck rack. Holly and Sinclair are the only customers at this terminal.

Spokane Terminal

This terminal is connected to the Woods Cross Refinery via a Chevron common carrier pipeline. The Spokane terminal also is supplied by Chevron and Yellowstone pipelines and by rail and truck. Refined products received at this terminal are sold locally, via the truck rack. Shell and Chevron are the major customers at this terminal. Other terminals in the Spokane area include terminals owned by ExxonMobil and ConocoPhillips.

Abilene Terminal

This terminal receives refined products from Alon s Big Spring Refinery, which accounted for all of its volumes in 2006. Refined products received at this terminal are sold locally via a truck rack or pumped over a 2-mile pipeline to Dyess Air Force Base. Alon is the only customer at this terminal.

Wichita Falls Terminal

This terminal receives refined products from Alon s Big Spring Refinery, which accounted for all of its volumes in 2006. Refined products received at this terminal are sold via a truck rack or shipped to Alon s terminal in Duncan, Oklahoma. Alon is the only customer at this terminal.

Orla Tank Farm

The Orla tank farm was constructed in 1998. It receives refined products from Alon s Big Spring Refinery that accounted for all of its volumes in 2006. Refined products received at the tank farm are delivered into our Orla to El Paso pipeline. Alon is the only customer at this tank farm.

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Artesia Facility Truck Rack

The truck rack at Holly s Artesia facility loads light refined products, produced at the facility, onto tanker trucks for delivery to markets in the surrounding area. Holly is the only customer of this truck rack.

Woods Cross Facility Truck Rack

The truck rack at Holly s Woods Cross facility loads light refined products produced at Holly s Woods Cross Refinery onto tanker trucks for delivery to markets in the surrounding area. Holly is the only customer of this truck rack; Holly also makes transfers to a common carrier pipeline at this facility.

PIPELINE AND TERMINAL CONTROL OPERATIONS

All of our pipelines are operated via geosynchronous satellite, microwave, radio and frame relay communication systems from our central control room located in Artesia, New Mexico. We also monitor activity at our terminals from this control room.

The control center operates with modern, state-of-the-art System Control and Data Acquisition, or SCADA, systems. Our control center is equipped with computer systems designed to continuously monitor operational data, including refined product and crude oil throughput, flow rates, and pressures. In addition, the control center monitors alarms and throughput balances. The control center operates remote pumps, motors, engines, and valves associated with the delivery of refined products and crude oil. The computer systems are designed to enhance leak-detection capabilities, sound automatic alarms if operational conditions outside of pre-established parameters occur, and provide for remote-controlled shutdown of pump stations on the pipelines. Pump stations and meter-measurement points on the pipelines are linked by satellite or telephone communication systems for remote monitoring and control, which reduces our requirement for full-time on-site personnel at most of these locations.

Item 3. Legal Proceedings

We are a party to various legal and regulatory proceedings, which we believe will not have a material adverse impact on our financial condition, results of operations or cash flows.

Item 4. Submission of Matters to a Vote of Security Holders

No matter was submitted to a vote of security holders during the fourth quarter of 2006.

PART II

Item 5. Market for the Registrant s Common Units, Related Unitholder Matters and Issuer Purchases of Common Units

Our common limited partner units began trading on the New York Stock Exchange under the symbol HEP commencing with our initial public offering on July 8, 2004. The following table sets forth the range of the daily high and low sales prices per common unit, cash distributions to common unitholders and the trading volume of common units for the period indicated.

Years Ended December 31,	High	Low	Cash Distributions	Trading Volume
2006				
Fourth Quarter	$41.10	$37.90	$ 0.665	876,800
Third Quarter	$40.44	$35.80	$ 0.655	957,700
Second Quarter	$42.58	$38.15	$ 0.640	704,100
First Quarter	$42.75	$37.00	$ 0.625	1,165,000
2005				
Fourth Quarter	$44.14	$35.80	$ 0.600	1,014,800
Third Quarter	$45.40	$39.10	$ 0.575	1,068,700
Second Quarter	$47.00	$37.28	$ 0.550	1,375,300
First Quarter	$40.45	$32.25	$ 0.500	1,825,100

A distribution for the quarter ended December 31, 2006 of $0.675 per unit was paid on February 14, 2007.

As of February 9, 2007, we had approximately 4,200 common unitholders, including beneficial owners of common units held in street name.

We consider 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 revolving credit facility 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. The indenture relating to our Senior Notes will prohibit us from making cash distributions under certain circumstances.

Within 45 days after the end of each quarter, we 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 facility and in all cases are used solely for working capital purposes or to pay distributions to partners.

Upon the closing of our initial public offering, Holly received 7,000,000 subordinated units. During the subordination period, the common units will 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 during the subordination period there will be available cash to be distributed on the common units. 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 our partnership agreement) generated during each of the three consecutive, non-overlapping 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 Class B subordinated units issued to Alon generally vote as a single class and rank equally with our existing subordinated units. There will be a subordination period with respect to the Class B subordinated units with generally similar provisions to the subordinated units held by Holly, except that the subordination period will end on the last day of any quarter ending on or after March 31, 2010 if Alon has not defaulted on its minimum volume commitment payment obligations for the three consecutive, non-overlapping four quarter periods immediately preceding that date, subject to certain grace periods. If Holly is removed as the general partner without cause, the subordination period for the Class B subordinated units may end before March 31, 2010.

We make distributions of available cash from operating surplus for any quarter during any subordination period in the following manner: first, 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; second, 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; third, 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.

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 Target Amount	Marginal Percentage Interest in 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%

In the fourth quarter of 2006, we paid $0.1 million for the purchase of 3,210 of our common units in the open market for the recipients of all 2006 restricted unit grants.

	Total Number of Units Purchased	Maximum Number of Units that May Yet Be Purchased

Period	Total Number of Units Purchased	Average Price Paid Per Unit	as Part of Publicly Announced Plan or Program	Under a Publicly Announced Plan or Program
October 2006		$		
November 2006		$		
December 2006	3,210	$ 38.14		
Total	3,210			

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Item 6. Selected Financial Data

The following table shows selected financial information for HEP. This table should be read in conjunction with Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations and the consolidated financial statements of HEP and related notes thereto included elsewhere in this Form 10-K.

			Combined	2004 Successor	Predecessor		
	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Ended December 31, 2004 (1)	July 13, 2004 Through December 31, 2004	January 1, 2004 Through July 12, 2004	Year Ended December 31, 2003	Year Ended December 31, 2002
	(In thousands, except per unit data)						
Statement Of Income Data:							
Revenue	$ 89,194	$ 80,120	$ 67,766	$ 28,182	$ 39,584	$ 30,800	$ 23,581
Operating costs and expenses							
Operations	28,630	25,332	23,641	10,104	13,537	24,193	19,442
Depreciation and amortization	15,330	14,201	7,224	3,241	3,983	6,453	4,475
General and administrative	4,854	4,047	1,860	1,859	1		
Total operating costs and expenses	48,814	43,580	32,725	15,204	17,521	30,646	23,917
Operating income (loss)	40,380	36,540	35,041	12,978	22,063	154	(336)
Interest income	899	649	144	65	79	291	269
Interest expense	(13,056)	(9,633)	(697)	(697)			
Equity in earnings of Rio Grande Pipeline Company						894	2,737
	(12,157)	(8,984)	(553)	(632)	79	1,185	3,006
Income before minority interest	28,223	27,556	34,488	12,346	22,142	1,339	2,670
Minority interest in Rio Grande	(680)	(740)	(1,994)	(956)	(1,038)	(758)	

Pipeline Company							
Net income	27,543	26,816	32,494	11,390	21,104	581	2,670
Less:							
Net income attributable to Predecessor			21,104		21,104	581	2,670
General partner interest in net income	1,710	721	228	228			
Limited partners interest in net income	$ 25,833	$ 26,095	$ 11,162	$ 11,162	$	$	$
Net income per limited partner unit basic and diluted	$ 1.60	$ 1.70		$ 0.80			
Cash distributions declared per unit applicable to limited partners	$ 2.585	$ 2.225		$ 0.435			
Other Financial Data:							
EBITDA [2]	$ 55,030	$ 50,001	$ 40,271	$ 15,263	$ 25,008	$ 6,743	$ 6,876
Cash flows from operating activities	$ 45,853	$ 42,628	$ 15,867	$ 15,371	$ 496	$ 5,909	$ 4,271
Cash flows from investing activities	$ (9,107)	$ (131,795)	$ (2,977)	$ (305)	$ (2,672)	$ (27,947)	$ (4,271)
Cash flows from financing activities	$ (45,774)	$ 90,646	$ (480)	$ 1,770	$ (2,250)	$ 28,372	$
Maintenance capital expenditures [3]	$ 1,095	$ 364	$ 1,197	$ 305	$ 892	$ 1,934	$ 1,178
Expansion capital expenditures	8,012	3,519	1,780		1,780	4,837	5,580
Total capital expenditures	$ 9,107	$ 3,883	$ 2,977	$ 305	$ 2,672	$ 6,771	$ 6,758
Balance Sheet Data (at period							

end):							
Net property, plant and equipment	$ 160,484	$ 162,298	$ 74,626	$ 74,626	$ 95,337	$ 95,826	$ 60,073
Total assets	$ 243,573	$ 254,775	$ 103,758	$ 103,758	$ 156,373	$ 140,425	$ 88,338
Long-term debt	$ 180,660	$ 180,737	$ 25,000	$ 25,000	$	$	$
Total liabilities	$ 196,384	$ 190,962	$ 28,998	$ 28,998	$ 53,146	$ 57,089	$ 20,059
Net partners equity [(4)]	$ 36,226	$ 52,060	$ 61,528	$ 61,528	$ 89,964	$ 68,860	$ 68,279

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(1) Combined results for the year ended December 31, 2004 is not a calculation based upon U.S. generally accepted accounting principles (GAAP), and is presented here to provide the investor with additional information for comparing year-over-year information.

(2) Earnings before interest, taxes, depreciation and amortization (EBITDA) are calculated as net income plus (a) interest expense net of interest income and (b) depreciation and amortization. EBITDA is a non-GAAP measure. 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 enhances an investor s understanding of our ability to satisfy principal and interest obligations with respect to our indebtedness and to use cash for other purposes, including capital expenditures. EBITDA is also used by our management for internal analysis and as a basis for compliance with financial covenants. See Historical Results of Operations under Item 7, Management s Discussion and Analysis of Financial Condition and Results of Operations, for certain changes made effective January 1, 2004 in how we recorded transactions, which would affect the comparability of EBITDA for periods after January 1, 2004 with EBITDA for the prior years.

Reconciliation of EBITDA to net income	**Year Ended December 31, 2006**	**Year Ended December 31, 2005**	**Combined Year Ended December 31, 2004**	**2004 Successor July 13, 2004 Through December 31, 2004**	**2004 Predecessor January 1, 2004 Through July 12,2004**	**Year Ended December 31,2003**	**Year Ended December 31,2002**
				(In thousands)			
Net income	$ 27,543	$ 26,816	$ 32,494	$ 11,390	$ 21,104	$ 581	$ 2,670
Add depreciation and amortization	15,330	14,201	7,224	3,241	3,983	6,453	4,475
Add interest expense	13,056	9,633	697	697			
Subtract interest income	(899)	(649)	(144)	(65)	(79)	(291)	(269)
EBITDA	$ 55,030	$ 50,001	$ 40,271	$ 15,263	$ 25,008	$ 6,743	$ 6,876

(3) 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.

(4) 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 have exceeded our quarterly net income.

Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations

This Item 7, including but not limited to the sections on Liquidity and Capital Resources , contains forward-looking statements. See Forward-Looking Statements at the beginning of Part I. In this document, the words we , our , ours a us refer to HEP and its consolidated subsidiaries or to HEP or an individual subsidiary and not to any other person.

OVERVIEW

HEP is a Delaware limited partnership formed by Holly and is the successor to NPL. HEP was formed to acquire, own and operate substantially all of the refined product pipeline and terminalling assets that support Holly s refining and marketing operations in west Texas, New Mexico, Utah and Arizona and a 70% interest in Rio Grande. On July 7, 2004, we priced 6,100,000 common units for the initial public offering and on July 8, 2004, our common units began trading on the New York Stock Exchange under the symbol HEP. On July 13, 2004, we closed our initial public offering of 7,000,000 common units at a price of $22.25 per unit, which included a 900,000 unit over-allotment option that was exercised by the underwriters. Total proceeds from the sale of the units were $145.5 million, net of $10.3 million of underwriting commissions. All the initial assets of HEP were contributed by Holly and its subsidiaries in exchange for (a) 7,000,000 subordinated units, representing 49% limited partner interest in HEP, (b) incentive distribution rights, (c) the 2% general partner interest and d) an aggregate cash distribution of $125.6 million.

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.

On February 28, 2005, we acquired from Alon four refined products pipelines, an associated tank farm and two refined products terminals located primarily in Texas that serve Alon s Big Spring, Texas refinery. Please read Alon Transaction under Liquidity and Capital Resources below for additional information.

On July 8, 2005, we acquired Holly s Intermediate Pipelines which connect its Lovington, New Mexico and Artesia, New Mexico refining facilities. Please read Holly Intermediate Pipelines Transaction under Liquidity and Capital Resources below for additional information.

As a result of the Alon transaction, Holly s ownership interest was reduced from 51% to 47.9%, including the 2% general partner interest. Holly s ownership was further reduced to 45.0% in July 2005 following the Intermediate Pipelines transaction.

Historical Results of Operations

In reviewing the historical results of operations that are discussed below, you should be aware of the following:

Until January 1, 2004, our historical revenues included only actual amounts received from:

- third parties who utilized our pipelines and terminals;
- Holly for use of our FERC-regulated refined product pipeline; and
- Holly for use of the Lovington crude oil pipelines, which were not contributed to our partnership.

Until January 1, 2004, we did not record revenue for:

- transporting products for Holly on our intrastate refined product pipelines;

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providing terminalling services to Holly; and

transporting crude oil and feedstocks on the Intermediate Pipelines that connect Holly s Artesia and Lovington facilities, which were not contributed to our partnership.

Commencing January 1, 2004, we began charging Holly fees for the use of all of our pipelines and terminals at the rates set forth in the Holly PTA described below under Agreements with Holly .

Furthermore, the historical financial data do not reflect any general and administrative expenses prior to July 13, 2004 as Holly did not historically allocate any of its general and administrative expenses to its pipelines and terminals. Our historical results of operations prior to July 13, 2004 include costs associated with crude oil and intermediate product pipelines, which were not contributed to our partnership.

For periods after commencement of operations by HEP on July 13, 2004, our financial statements reflect:

net proceeds from our initial public offering which closed on July 13, 2004 (see Liquidity and Capital Resources below);

the transfer of certain of our predecessor s operations to HEP, which

includes our predecessor s refined product pipeline and terminal assets and short-term debt due to Holly (which was repaid upon the closing of our initial public offering), and

excludes our predecessor s crude oil systems, intermediate product pipelines, accounts receivable from or payable to affiliates, and other miscellaneous assets and liabilities;

the execution of the Holly PTA and the recognition of revenues derived therefrom; and

the execution of the Omnibus Agreement with Holly and several of its subsidiaries and the recognition of allocated general and administrative expenses in addition to direct general and administrative expense related to our operation as a publicly owned entity.

NPL constitutes HEP s predecessor. The transfer of ownership of assets from NPL to HEP represented a reorganization of entities under common control and was recorded at NPL s historical cost. Accordingly, our financial statements include the historical results of operations of NPL prior to the transfer to HEP.

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Agreements with Holly

Under the 15-year Holly PTA, Holly pays us fees to transport on our refined product pipelines or throughput in our terminals a volume of refined products that will produce a minimum level of revenue. Following the July 1, 2006 PPI adjustment, the volume commitments by Holly under the Holly PTA will produce at least $38.5 million of revenue annually.

Prior to July 13, 2004, Holly did not allocate any of its general and administrative expenses to its pipeline and terminalling operations. Under the Omnibus Agreement, we pay Holly an annual administrative fee in the amount of $2.0 million for the provision by Holly or its affiliates of various general and administrative services to us. This fee does not include the salaries of pipeline and terminal personnel or other employees of HLS 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.

In connection with our acquisition of the Intermediate Pipelines, we entered into the 15-year Holly IPA. Under this agreement, Holly agreed to transport volumes of intermediate products on the Intermediate Pipelines that will produce a minimum level of funds to us. Following the July 1, 2006 PPI adjustment, the volume commitments by Holly under the Holly IPA will result in minimum funds to us of $12.4 million annually.

Please read Agreements with Holly under Item 1, Business for additional information on these agreements with Holly.

RESULTS OF OPERATIONS

The following tables present our operating income, volume information, and cash flow summary information for the years ended December 31, 2006, 2005 and 2004. Prior to January 1, 2004, we recorded pipeline tariff revenues only on FERC-regulated pipelines and terminal service fee revenues from third-party customers. No revenues from affiliates were recorded on non-FERC regulated pipelines and no terminal services fee revenues from affiliates were recorded for use of our terminal facilities. Commencing January 1, 2004, affiliate revenues have been recorded for all pipeline and terminal facilities included in our pipeline and terminal facilities. Additionally, the 2004 information is split for the period prior to our initial public offering, captioned Predecessor and for the period following our initial public offering, captioned Successor . The information for the 2004 Predecessor and Successor periods are added together and presented under the caption Combined. As a result, the information included in the following table of operating income is not fully comparable on a year-over-year basis.

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	Year Ended December 31, 2006	Year Ended December 31, 2005	Combined Year Ended December 31, 2004 [(1)]	2004 Successor July 13, 2004 through December 31, 2004	Predecessor January 1, 2004 through July 12, 2004
	(In thousands, except per unit data)				
Revenues					
Pipelines:					
Affiliates refined product pipelines	$ 31,723	$ 29,288	$ 28,533	$ 13,498	$ 15,035
Affiliates intermediate pipelines	10,733	4,643			
Third parties	31,685	31,447	18,952	8,915	10,037
	74,141	65,378	47,485	22,413	25,072
Terminals and truck loading racks:					
Affiliates	10,422	10,253	9,194	4,419	4,775
Third parties	4,631	4,489	3,179	1,349	1,830
	15,053	14,742	12,373	5,768	6,605
Other			15	1	14
Total for pipelines and terminal assets	89,194	80,120	59,873	28,182	31,691
Crude system and intermediate pipelines not contributed to HEP at inception [(2)]:					
Lovington crude oil pipelines			3,325		3,325
Intermediate pipelines			4,568		4,568
Total for crude system and intermediate pipeline assets not contributed to HEP at inception			7,893		7,893
Total revenues	89,194	80,120	67,766	28,182	39,584
Operating costs and expenses					
Costs related to pipeline and refined product terminal assets acquired by successor:					

Operations	28,630	25,332	21,361	10,104	11,257
Depreciation and amortization	15,330	14,201	6,791	3,241	3,550
General and administrative	4,854	4,047	1,860	1,859	1
	48,814	43,580	30,012	15,204	14,808
Crude system and intermediate pipelines not contributed to HEP at inception [2]:					
Operations			2,280		2,280
Depreciation and amortization			433		433
			2,713		2,713
Total operating costs and expenses	48,814	43,580	32,725	15,204	17,521
Operating income	40,380	36,540	35,041	12,978	22,063
Interest income	899	649	144	65	79
Interest expense, including amortization	(13,056)	(9,633)	(697)	(697)	
Minority interest in Rio Grande Pipeline Company	(680)	(740)	(1,994)	(956)	(1,038)
Net income	27,543	26,816	32,494	11,390	21,104
Less:					
Net income applicable to Predecessor			21,104		21,104
General partner interest in net income, including incentive distributions [3]	1,710	721	228	228	
Limited partners interest in net income	$ 25,833	$ 26,095	$ 11,162	$ 11,162	$
Net income per limited partner unit basic and diluted [3]	$ 1.60	$ 1.70		$ 0.80	
Weighted average limited partners units outstanding	16,108	15,356		14,000	
EBITDA [4]	$ 55,030	$ 50,001	$ 40,271	$ 15,263	$ 25,008

Distributable cash flow (5)	$	47,219	$ 41,438	$	14,492

	Year Ended December 31, 2006	Year Ended December 31, 2005	Combined Year Ended December 31, 2004	2004 Successor July 13, 2004 through December 31, 2004	Predecessor January 1, 2004 through July 12, 2004
Volumes (bpd) (6)					
Pipelines:					
Affiliates refined product pipelines	69,271	66,206	65,525	66,017	65,089
Affiliates intermediate pipelines	57,658	28,267			
Third parties	62,655	65,053	29,967	30,310	29,663
	189,584	159,526	95,492	96,327	94,752
Terminals and truck loading racks:					
Affiliates	118,202	120,795	114,991	114,690	115,259
Third parties	43,285	42,334	24,821	22,922	26,505
	161,487	163,129	139,812	137,612	141,764
Total for pipelines and terminal assets (bpd)	351,071	322,655	235,304	233,939	236,516

(1) Combined results for the year ended December 31, 2004 is not a calculation based upon U.S. generally accepted accounting principles (GAAP), and is presented here to provide the investor with additional information for comparing year-over-year information.

(2) Revenue and expense items generated by the crude system and Intermediate Pipeline assets that were not contributed to HEP at inception in July 2004. Historically, these items were included in the income of NPL as predecessor, but are not included in the income of HEP beginning July 13, 2004. The Intermediate Pipelines were later purchased by HEP on July 8, 2005.

(3) 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. The limited partners interest in net income is divided by the weighted average limited partner units outstanding in computing the net income per unit applicable to limited partners.

(4) Earnings before interest, taxes, depreciation and amortization (EBITDA) is calculated as net income plus (a) interest expense net of interest income and (b) depreciation and amortization. EBITDA is a non-GAAP measure. 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.

			Combined	2004 Successor	Predecessor
	Year Ended December 31, 2006	Year Ended December 31, 2005	Year Ended December 31, 2004	July 13, 2004 through December 31, 2004	January 1, 2004 through July 12, 2004
			(In thousands)		
Net income	$ 27,543	$ 26,816	$ 32,494	$ 11,390	$ 21,104
Add interest expense	12,088	8,848	531	531	
Add amortization of discount and deferred debt issuance costs	968	785	166	166	
Subtract interest income	(899)	(649)	(144)	(65)	(79)
Add depreciation and amortization	15,330	14,201	7,224	3,241	3,983
EBITDA	$ 55,030	$ 50,001	$ 40,271	$ 15,263	$ 25,008

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(5) 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.

Set forth below is our calculation of distributable cash flow attributable to partners subsequent to the formation on July 13, 2004.

	Successor		
	Year Ended December 31, 2006	Year Ended December 31, 2005	July 13, 2004 through December 31, 2004
		(In thousands)	
Net income	$ 27,543	$ 26,816	$ 11,390
Add depreciation and amortization	15,330	14,201	3,241
Add amortization of discount and deferred debt issuance costs	968	785	166
Increase in deferred revenue	4,473		
Subtract maintenance capital expenditures*	(1,095)	(364)	(305)
Distributable cash flow	$ 47,219	$ 41,438	$ 14,492

* 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.

(6) The amounts reported represent volumes from the initial assets contributed to HEP at inception in July 2004 and additional volumes from the assets acquired from Alon starting in March 2005 and the Intermediate Pipelines acquired from Holly starting in July 2005. The amounts reported in the 2005 periods include volumes on the acquired assets subsequent to the respective acquisition dates averaged over the full reported periods.

Results of Operations Year Ended December 31, 2006 Compared with Year Ended December 31, 2005

Summary

Net income was $27.5 million for the year ended December 31, 2006, an increase of $0.7 million from $26.8 million for the year ended December 31, 2005. The increase in overall earnings was principally due to the earnings generated from the Intermediate Pipelines acquired from Holly on July 8, 2005, for which we realized earnings for only six months in 2005, and increases in volumes transported by affiliates on our intermediate and refined product pipeline systems following Holly s completion in June 2006 of an expansion of the Navajo Refinery. Also favorably impacting earnings in 2006 were the effects of the annual tariff increases on our pipelines and the recognition of certain previously deferred revenue. Partially offsetting these positive factors was a reduction of volumes transported and terminalled in the second quarter of 2006 due to significant refinery downtime experienced by all of the refineries utilizing our refined product distribution network (described below) and higher interest expense principally related to the senior notes issued in connection with the pipeline and terminal assets acquired from Alon in early 2005 and the Intermediate Pipelines acquired from Holly in July 2005.

Revenues

Revenues of $89.2 million for the year ended December 31, 2006 were $9.1 million greater than the $80.1 million for the comparable period of 2005. This increase was principally due to an increase in volumes transported on the pipeline and terminal assets acquired from Alon in early 2005 and the Intermediate Pipelines acquired from Holly in July 2005, for which we realized revenues for only ten and six of the twelve months of 2005, respectively. Additionally, favorably impacting revenues for the year ended December 31, 2006 was the recognition of certain previously deferred revenue, an increase in volumes transported by affiliates following the Navajo Refinery expansion, and the effects of the annual tariff increases on our pipelines. Partially offsetting these increases, was a reduction of volumes transported and terminalled in the second quarter of 2006 due to significant refinery downtime experienced by all of the refineries utilizing our refined product distribution network as discussed below. Also impacting revenue for the year ended December 31, 2006, BP completed its obligation to pay the border crossing fee under BP s Rio Grande Pipeline contract in 2005. We did not have border crossing fee revenues for the year ended December 31, 2006, due to the fulfillment of this contract.

All of the refineries utilizing our refined product distribution network, 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, significant downtime at the refineries was required during the quarter ended June 30, 2006, so that ULSD-associated projects could be brought on line. Additionally, Holly completed an expansion of the Navajo Refinery, which required additional unit downtime. 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.

Revenues from refined product pipelines increased by $2.7 million from $60.7 million for the year ended December 31, 2005 to $63.4 million for the year ended December 31, 2006. Shipments on our refined product pipelines averaged 131.9 thousand barrels per day (mbpd) for the year ended December 31, 2006 as compared to 131.3 mbpd for the year ended December 31, 2005. Refined product pipeline revenues for the year ended December 31, 2006 were negatively impacted due to BP s completion of its border crossing fee obligations under BP s Rio Grande Pipeline contract in early 2005. We had no border crossing fee revenues for the year ended December 31, 2006 as compared to $0.8 million in 2005 due to the fulfillment of this contract.

Revenues from the Intermediate Pipelines increased by $6.1 million from $4.6 million for the year ended December 31, 2005 to $10.7 million for the year ended December 31, 2006. This increase includes $1.0

million attributable to the recognition of previously deferred revenue as the contractual period for us to provide certain pipeline services had expired. Shipments on the Intermediate Pipelines averaged 57.7 mbpd for the year ended December 31, 2006 as compared to 28.3 mbpd for the year ended December 31, 2005. The increase was principally due to realizing revenues for a full twelve months of volumes during the year ended December 31, 2006, while we realized revenues for only six months during the year ended December 31, 2005.

Revenues from terminal and truck loading rack service fees increased by $0.4 million from $14.7 million for the year ended December 31, 2005 to $15.1 million for the year ended December 31, 2006, principally due to rates increases in terminal fees charged to our affiliates. Refined products terminalled in our facilities for the comparable periods decreased to 161.5 mbpd in the year ended December 31, 2006 from 163.1 mbpd in the year ended December 31, 2005.

Operations Expense

Operations expense increased $3.3 million from the year ended December 31, 2005 to the year ended December 31, 2006. This increase in expense was principally due to $2.2 million of increased direct operating costs relating to the assets acquired from Alon and direct operating costs of $0.7 million for the Intermediate Pipelines that were acquired in July 2005. Additionally impacting operations expense were other year-over-year increases in pipeline and terminal maintenance expense and direct operating costs relating to the personnel who support our operations.

Depreciation and Amortization

Depreciation and amortization was $1.1 million higher in the year ended December 31, 2006 than in the year ended December 31, 2005, due principally to the increase in depreciation from the pipeline and terminal assets acquired from Alon in 2005.

General and Administrative

General and administrative costs were $4.9 million for the year ended December 31, 2006, an increase of $0.9 million from $4.0 million for the year ended December 31, 2005 due mainly to equity-based compensation expense and business development costs.

Interest Expense

Interest expense for the year ended December 31, 2006 totaled $13.1 million, an increase of $3.5 million from $9.6 million for the year ended December 31, 2005. The increase is due to the debt issued in connection with the Alon and Intermediate Pipelines acquisitions. In the year ended December 31, 2006, interest expense consisted of: $11.6 million of interest on the outstanding debt, net of the impact of the interest rate swap; $0.5 million of commitment fees on the unused portion of the Credit Agreement; and $1.0 million of amortization of the discount on the Senior Notes and deferred debt issuance costs. In the year ended December 31, 2005, interest expense consisted of: $8.4 million of interest on the outstanding debt, net of the impact of the interest rate swap; $0.4 million of commitment fees on the unused portion of the Credit Agreement; and $0.8 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 for the year ended December 31, 2006 was comparable to the year ended December 31, 2005. The minority interest in Rio Grande reduced our income by $0.7 million for the years ended December 31, 2006 and 2005.

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Results of Operations Year Ended December 31, 2005 Compared with Year Ended December 31, 2004

Summary

Net income was $26.8 million for the year ended December 31, 2005, a decrease of $5.7 million from $32.5 million for the year ended December 31, 2004. The decrease in income was principally due to the inclusion in earnings of $5.2 million in the prior year period of the crude oil and Intermediate Pipelines that were not contributed to the Partnership at inception, reduced revenues from Rio Grande, general and administrative charges currently being incurred by the Partnership that were not allocated prior to the initial public offering, and interest expense principally related to the Senior Notes issued in connection with the Alon and Intermediate Pipelines transactions, partially offset by the additional income generated from the assets acquired from Alon and the Intermediate Pipelines subsequently acquired from Holly, and additional revenues from our existing pipelines and terminals.

Revenues

Revenues of $80.1 million for the year ended December 31, 2005 were $12.3 million greater than the $67.8 million in the comparable period of 2004, principally due to $17.6 million of revenues from the pipeline and terminal assets acquired from Alon on February 28, 2005 and $4.6 million of revenues from the Intermediate Pipeline assets acquired from Holly on July 8, 2005, partially offset by revenues of $7.9 million in the year ended December 31, 2004 from assets not originally contributed to the Partnership. Also, we had additional revenues from our existing pipelines and terminals of $1.7 million and reduced revenues from the Rio Grande Pipeline of $3.7 million.

Revenues from refined product pipelines increased by $13.2 million from $47.5 million for the year ended December 31, 2004 to $60.7 million for the year ended December 31, 2005. Shipments on our refined product pipelines averaged 131.3 mbpd for the year ended December 31, 2005 as compared to 95.5 mbpd for the year ended December 31, 2004, principally due to the incremental March to December 2005 volumes from the pipelines acquired from Alon, combined with increased volumes shipped by Holly and its affiliates, partially offset by reduced volumes shipped on the Rio Grande Pipeline.

Revenues from the Intermediate Pipelines purchased from Holly in July 2005 contributed $4.6 million to revenue in the year ended December 31, 2005. Revenues from crude system and Intermediate Pipeline assets not contributed to HEP were $7.9 million for the year ended December 31, 2004, as a result of including operations of the predecessor only until July 13, 2004, the commencement of operations of HEP. As anticipated, during the first quarter of 2005, based on the aggregate volumes shipped by BP on the Rio Grande Pipeline, BP is no longer required to pay the border crossing fee pursuant to its contract. For the years ended December 31, 2005 and 2004, the border crossing fee was $0.8 million and $4.5 million, respectively.

Revenues from terminal and truck loading rack service fees increased by $2.3 million from $12.4 million for the year ended December 31, 2004 to $14.7 million for the year ended December 31, 2005. Refined products terminalled in our facilities for the comparable periods rose to 163.1 mbpd in the year ended December 31, 2005 from 139.8 mbpd in the year ended December 31, 2004, due to the incremental March to December 2005 volumes from the terminals acquired from Alon and volume gains at our existing terminals.

Operations Expense

Operations expense increased $1.7 million from the year ended December 31, 2004 to the year ended December 31, 2005. This increase in expense was principally due to $3.4 million of operating costs relating to the assets acquired from Alon, combined with operating costs of $0.6 million for the Intermediate Pipelines that were acquired in July 2005, partially offset by operating costs of $2.3 million for the crude oil and Intermediate Pipelines that were not contributed to HEP in July 2004.

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Depreciation and Amortization

Depreciation and amortization was $7.0 million higher in the year ended December 31, 2005 than in the year ended December 31, 2004, due principally to the increase in depreciation from the assets acquired from Alon.

General and Administrative

General and administrative costs were $4.0 million for the year ended December 31, 2005, an increase of $2.1 million from $1.9 million for the year ended December 31, 2004. No general and administrative costs were incurred prior to HEP s formation date of July 13, 2004, as Holly did not allocate any general and administrative costs to its subsidiaries.

Interest Expense

Interest expense for the year ended December 31, 2005 totaled $9.6 million, an increase of $8.9 million from $0.7 million for the year ended December 31, 2004. The increase is due to the debt issued in connection with the Alon and Intermediate Pipelines acquisitions. In the year ended December 31, 2005, interest expense consisted of: $8.4 million of interest on the outstanding debt, net of the impact of the interest rate swap; $0.4 million of commitment fees on the unused portion of the Credit Agreement; and $0.8 million of amortization of the discount on the Senior Notes and deferred debt issuance costs. As no interest expense was incurred prior to formation on July 13, 2004, only $0.7 million of interest expense was recorded on the Credit Agreement and commitment fees for the year ended December 31, 2004.

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 $0.7 million in year ended December 31, 2005 compared to $2.0 million in the year ended December 31, 2004.

LIQUIDITY AND CAPITAL RESOURCES

Overview

In conjunction with our initial public offering on July 13, 2004, we entered into a four-year, $100.0 million senior secured revolving credit agreement. During 2005, amendments were made to the Credit Agreement to allow for the closing of the Alon transaction and the related Senior Notes offering, the closing of the Holly Intermediate Pipelines transaction and to amend certain of the restrictive covenants. As of December 31, 2006, we had no amounts outstanding under the Credit Agreement. The Credit Agreement is available to fund capital expenditures, acquisitions, and working capital and for general partnership purposes.

We financed the $120.0 million cash portion of the consideration for the Alon transaction through our private offering on February 28, 2005 of $150.0 million of 6.25% Senior Notes due 2015. We used the balance to repay $30.0 million of outstanding indebtedness under our Credit Agreement, including $5.0 million drawn shortly before the closing of the Alon transaction. We financed a portion of the cash consideration for the Intermediate Pipelines transaction with the private offering in June 2005 of an additional $35.0 million in principal amount of the Senior Notes. On July 28, 2005, we filed a registration statement to allow the holders of the Senior Notes to exchange the Senior Notes for exchange notes registered with the SEC with substantially identical terms, which exchange was completed in October 2005.

We financed a portion of the cash consideration paid for the Intermediate Pipelines with $45.1 million of proceeds raised from the private sale of 1,100,000 of our common units to a limited number of institutional investors which closed simultaneously with the closing of the acquisition of the Intermediate Pipelines on July 8, 2005. On September 2, 2005, we filed a registration statement with the SEC using a shelf registration process which allows the institutional investors to freely transfer their units.

Additionally under this shelf 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.

As of December 31, 2006, we have no amounts outstanding under the Credit Agreement, and now have $100.0 million available and unused under our revolving credit facility. 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 February, May, August and November 2006, we paid regular quarterly cash distributions of $0.625, $0.64, $0.655 and $0.665, respectively, on all units, an aggregate amount of $43.7 million. Included in these distributions was an aggregate of $1.2 million paid to the general partner as incentive distributions, as the quarterly distributions per unit exceeded the target distribution amount of $0.55.

Cash and cash equivalents decreased by $9.0 million during the year ended December 31, 2006. The cash flow generated from operating activities of $45.9 million was less than cash used for investing and financing activities of $9.1 million and $45.8 million, respectively. Working capital decreased by $10.0 million to $9.5 million during the year ended December 31, 2006.

Cash Flows Operating Activities

Year Ended December 31, 2006 Compared with Year Ended December 31, 2005

Cash flows from operating activities increased by $3.3 million from $42.6 million for the year ended December 31, 2005 to $45.9 million for the year ended December 31, 2006. This increase is mainly due to $13.5 million additional cash collections from customers on the Alon assets and Intermediate Pipelines purchased in 2005. This increase of cash collections is partially offset by increased operations expense of $2.8 million on these new assets and increased cash payments for interest of $7.1 million, principally on the debt issued for these acquisitions. The remaining decrease in cash flows from operating activities is due to miscellaneous year-over-year changes in collections and payments, offset by lower pre-payments in 2006.

As discussed above, our major shippers are obligated to make deficiency payments to us if we do not receive certain minimum revenue payments. The shippers then have the right to recapture these amounts if future revenues exceed certain levels. During the year ended December 31, 2006, we received cash payments of approximately $5.6 million under these commitments, of which $0.9 million was recaptured in 2006. We collected $1.0 million during the year ended December 31, 2005 related to 2005 shortfalls, which expired without recapture and was recognized as revenue in the year ended December 31, 2006. Another $1.3 million is included in our accounts receivable at December 31, 2006 related to shortfalls produced in the fourth quarter of 2006.

Year Ended December 31, 2005 Compared with Year Ended December 31, 2004

Cash flows from operating activities increased by $26.7 million from $15.9 million for the year ended December 31, 2004 to $42.6 million for the year ended December 31, 2005. Cash flows from operating activities for 2004 were comparatively low principally because Holly utilized a common treasury function for all of its subsidiaries prior to our formation on July 13, 2004, whereby all cash receipts were deposited in Holly bank accounts and all cash disbursements were made from these common accounts. Thus, prior to our initial public offering, no cash balances were reflected in the accounts of HEP s predecessor, NPL, other than the cash balances of Rio Grande. Accordingly, $33.0 million of NPL s revenue and $12.2 million of operations expense prior to formation of HEP were not included in HEP s cash flows in 2004.

The acquisitions of the Alon assets and the Intermediate Pipelines impacted operating cash flows by providing $21.8 million of customer collections and $4.5 million of expenditures in 2005. Our net interest expense increased $8.9 million, principally for the issuances of Senior Notes to finance the Alon assets and Intermediate Pipelines acquisitions. Also, our expenditures for general and administrative costs increased by $2.5 million from 2004 to 2005, due mainly to the fact that Holly did not allocate general and administrative expenses to us prior to our formation in 2004.

Cash Flows Investing Activities

Year Ended December 31, 2006 Compared with Year Ended December 31, 2005

Cash flows used for investing activities decreased by $122.7 million from $131.8 million for the year ended December 31, 2005 to $9.1 million for the year ended December 31, 2006. On February 28, 2005, we closed on the Alon transaction which required $120.0 million in cash plus transaction costs of $2.0 million. Additionally, we issued 937,500 Class B subordinated units valued at $24.7 million to Alon as part of the consideration. See Alon Transaction below for additional information. On July 8, 2005, we closed on the acquisition of the Holly Intermediate Pipelines for $81.5 million, which consisted of $77.7 million in cash, 70,000 common units of HEP and a capital account credit of $1.0 million to maintain Holly s existing general partner interest in the Partnership. As this was a transaction between entities under common control, we recorded the acquired assets at Holly s historic book value. This resulted in payment to Holly of a purchase price of $71.9 million in excess of the basis of the assets received, which is included in cash flows from financing activities. See Holly Intermediate Pipelines Transaction below for additional information. Additions to properties and equipment for the year ended December 31, 2006 was $9.1 million, an increase of $5.2 million from $3.9 million for the year ended December 31, 2005.

Year Ended December 31, 2005 Compared with Year Ended December 31, 2004

Cash flows used for investing activities increased by $128.8 million from $3.0 million for the year ended December 31, 2004 to $131.8 million for the year ended December 31, 2005. On February 28, 2005, we closed on the Alon transaction which required $120.0 million in cash plus transaction costs of $2.0 million. Additionally, we issued 937,500 Class B subordinated units valued at $24.7 million to Alon as part of the consideration. See Alon Transaction below for additional information. On July 8, 2005, we closed on the acquisition of the Holly Intermediate Pipelines for $81.5 million, which consisted of $77.7 million in cash, 70,000 common units of HEP and a capital account credit of $1.0 million to maintain Holly s existing general partner interest in the Partnership. As this was a transaction between entities under common control, we recorded the acquired assets at Holly s historic book value. This resulted in payment to Holly of a purchase price of $71.9 million in excess of the basis of the assets received, which is included in cash flows from financing activities. See Holly Intermediate Pipelines Transaction below for additional information. Additions to properties and equipment for the year ended December 31, 2005 was $3.9 million, an increase of $0.9 million from $3.0 million for the year ended December 31, 2004.

Cash Flows Financing Activities

Year Ended December 31, 2006 Compared with Year Ended December 31, 2005

Cash flows used for financing activities amounted to $45.8 million for the year ended December 31, 2006. This compared to cash flows provided by financing activities of $90.6 million for the year ended December 31, 2005. In February 2005, we received proceeds of $147.4 million from the issuance of Senior Notes in connection with the Alon asset acquisition. Additionally, we used proceeds from the original Senior Note offering to repay $30.0 million of outstanding indebtedness under our Credit Agreement, including $5.0 million drawn shortly before the closing of the Alon transaction. In June 2005, in anticipation of the July Holly Intermediate Pipelines transaction, we received additional proceeds from Senior Notes issued of $33.8 million. See Senior Notes Due 2015 below for additional information. We financed a portion of the cash consideration paid for the Intermediate Pipelines with $45.1 million of proceeds raised from the private sale of 1,100,000 of our common units to a limited number of institutional investors which closed simultaneously with the closing of the acquisition of the Intermediate Pipelines on July 8, 2005. Of the cash paid to Holly for the Intermediate Pipelines, the excess cash paid over the asset basis was $71.9 million. During the year ended December 31, 2006, we paid cash distributions on all units and the general partner interest in the aggregate amount of $43.7 million, an increase of $8.7 million from $35.0 million in distributions paid during the year ended December 31, 2005. Distributions to the minority interest owner in Rio Grande were $1.5 million for the year ended December 31, 2006, a decrease of $0.7 million from $2.2 million for the year months ended December 31, 2005. Other cash flows from financing activities during the year ended December 31, 2005 included an additional capital contribution from our general partner of $0.6 million and deferred debt issuance costs incurred of $1.2 million.

Year Ended December 31, 2005 Compared with Year Ended December 31, 2004

Cash flows provided by financing activities amounted to $90.6 million for the year ended December 31, 2005. This compared to cash flows used in financing activities of $0.5 million in the year ended December 31, 2004. In February 2005, we received proceeds of $147.4 million from the issuance of Senior Notes in connection with the Alon asset acquisition. Additionally, we used proceeds from the original senior note offering to repay $30.0 million of outstanding indebtedness under our Credit Agreement, including $5.0 million drawn shortly before the closing of the Alon transaction. In June 2005, in anticipation of the July 2005 Holly Intermediate Pipelines transaction, we received additional proceeds from Senior Notes issued of $33.9 million. See Senior Notes Due 2015 below for additional information. We financed a portion of the cash consideration paid for the Intermediate Pipelines with $45.1 million of proceeds raised from the private sale of 1,100,000 of our common units to a limited number of institutional investors which closed simultaneously with the closing of the acquisition of the Intermediate Pipelines on July 8, 2005. Of the cash paid to Holly for the Intermediate Pipelines, the excess cash paid over the asset basis was $71.9 million. During 2005, we paid cash distributions on all units and the general partner interest in the aggregate amount of $35.0 million. Other cash flows from financing activities during the year ended December 31, 2005 included an additional capital contribution from our general partner of $0.6 million and deferred debt issuance costs incurred of $1.2 million. We completed our initial public offering of 7,000,000 common units on July 13, 2004, receiving net proceeds of $145.5 million and drawing $25.0 million on our Credit Agreement. The proceeds from these financings were utilized to repay $30.1 million owed to Holly as well as making a $125.6 million distribution to Holly. In addition, we used $3.5 million to pay for offering costs and $1.4 million to pay deferred debt issuance costs associated with our Credit Agreement. We also paid $0.7 million in late 2004 in deferred debt costs relating to the financing of the then pending Alon transaction. Distributions to the minority interest owner in Rio Grande were $2.2 million for the year ended December 31, 2005, a decrease of $1.0 million from $3.2 million for the year months ended December 31, 2004.

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 or construct 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 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 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 is being built to 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. This investment is expected to take the place of a project that we had been considering to construct and operate a new pipeline called the Porcupine Ridge Pipeline to transport crude oil from the Utah terminus of the Frontier Pipeline to Salt Lake City.

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 four-year $100 million senior secured revolving Credit Agreement.

The HLS board of directors is also considering a project to construct a 12-inch pipeline from Salt Lake City to Las Vegas, with service also to the Cedar City, Utah area. The initial capacity of the pipeline would be approximately 62,000 bpd, and it is expected that the capacity could be later increased up to approximately 118,000 bpd by adding pump stations. The cost of the pipeline is expected to be approximately $235 million, and the total cost of the project including terminals is expected to be approximately $300 million. We are currently in the process of soliciting potential shippers for binding commitments through an open season extending to the latter part of March 2007, and we expect to make a final decision on whether to proceed with this project based on the level of commitment from shippers. Certain preliminary work has already been carried out on this project by Holly, but as of the date of this report we have not expended HEP funds or committed to do so with respect to the project. If we choose to carry out this project, our financing for the project would include reimbursement to Holly for previous expenditures and assumption of any commitments previously made by Holly with respect to the project, and might also involve an investment in the project by one or more other companies, making our investment proportionately less.

We expect to use the issuance of common units and/or debt securities 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

In conjunction with our initial public offering on July 13, 2004, we entered into a four-year, $100.0 million senior secured revolving Credit Agreement. Union Bank of California, N.A. is a lender and serves as administrative agent under this agreement. Upon closing of our initial public offering, we drew $25.0 million under the Credit Agreement, which was outstanding at December 31, 2004.

We amended the Credit Agreement effective February 28, 2005 to allow for the closing of the Alon transaction and the related Senior Notes offering as well as to amend certain of the restrictive covenants. With a portion of the proceeds from the Senior Notes offering, we repaid $30.0 million of outstanding indebtedness under the Credit Agreement, including $5.0 million drawn shortly before the closing of the Alon transaction. As of June 17, 2005, we amended the Credit Agreement to restate the definition of certain terms used in the restrictive covenants. Additionally, we amended the Credit Agreement effective July 8, 2005 to allow for the closing of the Holly Intermediate Pipelines transaction as well as to amend certain of the restrictive covenants. As of December 31, 2006, we had no amounts outstanding under the Credit 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.

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. At December 31, 2006, 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

We financed the $120.0 million cash portion of the consideration for the Alon transaction through our private offering on February 28, 2005 of $150.0 million principal amount of 6.25% Senior Notes due 2015. We used the balance to repay $30.0 million of outstanding indebtedness under our Credit Agreement, including $5.0 million drawn shortly before the closing of the Alon transaction. We financed a portion of the cash consideration for the Intermediate Pipelines transaction with the private offering in June 2005 of an additional $35.0 million in principal amount of the Senior Notes.

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 $180.7 on our accompanying consolidated balance sheet at December 31, 2006. The difference is due to the $3.1 million unamortized discount and $1.2 relating to the fair value of the interest rate swap contract discussed below.

Alon Transaction

The total consideration paid for the Alon pipeline and terminal assets was $120.0 million in cash and 937,500 of our Class B subordinated units which, subject to certain conditions, will convert into an equal number of common units in five years. We financed the cash portion of the Alon transaction through our private offering of the $150.0 million Senior Notes. We used the proceeds of the offering to fund the $120.0 million cash portion of the consideration for the Alon transaction, and used the balance to repay $30.0 million of outstanding indebtedness under our Credit Agreement, including $5.0 million drawn shortly before the closing of the Alon transaction. In connection with the Alon transaction, we entered into the 15-year Alon PTA. Under the Alon PTA, Alon agreed to transport on our pipelines and throughput in our terminals a volume of refined products that would result in minimum revenue levels each year that will change annually based on changes in the PPI, but will not decrease below the initial $20.2 million annual amount. The total annual commitment following the March 1, 2006 PPI adjustment, is $20.5 million.

The consideration for the Alon pipeline and terminal assets was allocated to the individual assets acquired based on their estimated fair values as determined by an independent appraisal. The aggregate consideration amounted to $146.7 million, which consisted of $24.7 million fair value of our Class B subordinated units, $120.0 million in cash and $2.0 million of transaction costs. In accounting for this acquisition, we recorded pipeline and terminal assets of $86.7 million and an intangible asset of $60.0 million, representing the value of the 15-year pipelines and terminals agreement for transportation.

Holly Intermediate Pipelines Transaction

On July 6, 2005, we entered into the Purchase Agreement with Holly to acquire Holly s two 65-mile parallel Intermediate Pipelines which connect its Lovington, New Mexico and Artesia, New Mexico refining facilities. On July 8, 2005, we closed on the acquisition for $81.5 million, which consisted of $77.7 million in cash, 70,000 common units of HEP and a capital account credit of $1.0 million to maintain Holly s existing general partner interest in the Partnership. We financed the cash portion of the consideration for the Intermediate Pipelines with the proceeds raised from (a) the private sale of 1,100,000 of our common units for $45.1 million to a limited number of institutional investors which closed simultaneously with the acquisition and (b) an additional $35.0 million in principal amount of our 6.25% Senior Notes due 2015. This acquisition was made pursuant to an option to purchase these pipelines granted by Holly to us at the time of our initial public offering in July 2004.

In connection with this transaction, we entered into a 15-year pipelines agreement with Holly. Under this agreement, Holly agreed to transport volumes of intermediate products on the Intermediate Pipelines that, at the agreed tariff rates, will result in minimum funds to us of $11.8 million in the initial contract year. The total annual commitment following the July 1, 2006 PPI adjustment, is $12.4 million.

As this transaction is among entities under common control, we recorded the acquired assets at Holly s historic book value of $6.8 million. This resulted in payment to Holly of a purchase price of $71.9 million in excess of the basis of the assets received and a $71.9 million reduction of our net partners equity.

Contractual Obligations and Contingencies

The following table presents our long-term contractual obligations as of December 31, 2006.

The pipeline operating lease amounts below reflect the exercise of the first of three 10-year extensions, effective July 2007, on our lease agreement for the refined products pipeline between White Lakes Junction and Kuntz Station in New Mexico. However, these amounts exclude the second and third 10-year lease extensions which are likely to be exercised.

Most of our right of way agreements are renewable on an annual basis, and the right of way lease payments below include only obligations under the remaining non-cancelable terms of these agreements at December 31, 2006. For the foreseeable future, we intend to continue renewing these agreements and expect to incur right of way expenses in addition to the payments listed below.

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	Payments Due by Period				
	Total	Less than 1 Year	2-3 Years	4-5 Years	Over 5 Years
			(In thousands)		
Long-term debt principal	$ 185,000	$	$	$	$ 185,000
Long-term debt interest	98,281	11,563	23,125	23,125	40,468
Pipeline operating lease	61,401	5,848	11,695	11,695	32,163
Right of way leases	1,793	165	578	80	970
Other	2,174	1,781	393		
Total	$ 348,649	$ 19,357	$ 35,791	$ 34,900	$ 258,601

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 years ended December 31, 2006, 2005 and 2004.

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 2.5% annually over the past 5 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. For additional discussion on environmental matter, please see Environmental Regulation and Remediation under Item 1, 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.

Revenue Recognition

Revenues are recognized as products are shipped through our pipelines and terminals, except that prior to January 1, 2004, pipeline tariff and terminal services fee revenues were not recorded on services utilizing non-FERC regulated pipelines. These revenues had not previously been recognized as the pipelines and terminals were operated as a component of Holly s petroleum refining and marketing business. Commencing January 1, 2004, we began charging Holly pipeline tariffs and terminal service fees in the amounts set forth in the Holly PTA. Additional pipeline transportation revenues result from an operating lease by Alon USA, L.P. of an interest in the capacity of one of our pipelines.

Billings to customers for obligations under their quarterly minimum revenue commitments are recorded as deferred revenue liabilities if the customer has the right to receive future services for these billings. The revenue is recognized at the earlier of:

- the customer receives the future services provided by these billings,
- the period in which the customer is contractually allowed to receive the services expires, or
- we determine a high likelihood that we will not be required to provide services within the allowed period.

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The only revenues reflected in the historical financial data prior to January 1, 2004 are from (a) third parties who used our pipelines and terminals, (b) Holly s use of our Artesia, New Mexico to Orla, Texas to El Paso refined product pipeline and (c) Holly s use of the Lovington crude oil pipelines, which were not contributed to us.

Long-Lived Assets

We calculate depreciation and amortization based on estimated useful lives and salvage values of our assets. When assets are placed into service, we make estimates with respect to their useful lives that we believe are reasonable. However, factors such as competition, regulation or environmental matters could cause us to change our estimates, thus impacting the future calculation of depreciation and amortization. We evaluate long-lived assets for potential impairment by identifying whether indicators of impairment exist and, if so, assessing whether the long-lived assets are recoverable from estimated future undiscounted cash flows. The actual amount of impairment loss, if any, to be recorded is equal to the amount by which a long-lived asset s carrying value exceeds its fair value. Estimates of future discounted cash flows and fair value of assets require subjective assumptions with regard to future operating results, and actual results could differ from those estimates. No impairments of long-lived assets were recorded during the years ended December 31, 2006, 2005 and 2004.

Contingencies

It is common in our industry to be subject to proceedings, lawsuits and other claims related to environmental, labor, product and other matters. We are required to assess the likelihood of any adverse judgments or outcomes to these types of matters as well as potential ranges of probable losses. A determination of the amount of reserves required, if any, for these types of contingencies is made after careful analysis of each individual issue. The required reserves may change in the future due to developments in each matter or changes in approach such as a change in settlement strategy in dealing with these potential matters.

Recent Accounting Pronouncements

Statement of Financial Accounting Standards (SFAS) No. 154 Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and SFAS No. 3. This statement changes the requirements for accounting for and reporting a change in accounting principle and applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. We adopted this standard effective January 1, 2006. The adoption of this standard did not have a material effect on our financial condition, results of operations and cash flows.

Interpretation No. 48 Accounting for Uncertainty in Income Taxes

In June 2006, the 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 derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. We do not anticipate that the adoption of this interpretation will have a material effect on our financial condition, results of operations and cash flows.

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SFAS No. 157 Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This standard simplifies and codifies guidance on fair value measurements under generally accepted accounting principles. This standard defines fair value, establishes a framework for measuring fair value and prescribes expanded disclosures about fair value measurements. This standard is effective for fiscal years beginning after November 15, 2007. We do not anticipate that the adoption of this interpretation will have a material effect 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 December 31, 2006 was 6.5269%, 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 $1.2 million is included in Other long-term liabilities in our accompanying consolidated balance sheet at December 31, 2006. 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 December 31, 2006.

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 December 31, 2006, 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 December 31, 2006 would result in a change of approximately $5.2 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 December 31, 2006, 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 7A. Quantitative and Qualitative Disclosures about Market Risk

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.

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Item 8. Financial Statements and Supplementary Data

MANAGEMENT S REPORT ON ITS ASSESSMENT OF THE COMPANY S INTERNAL CONTROL OVER FINANCIAL REPORTING

Management of Holly Energy Partners, L.P. (the Partnership) is responsible for establishing and maintaining adequate internal control over financial reporting.

All internal control systems, no matter how well designed, have inherent limitations. Therefore, even those systems determined to be effective can provide only reasonable assurance with respect to financial statement preparation and presentation.

Management assessed the Partnership s internal control over financial reporting as of December 31, 2006 using the criteria for effective control over financial reporting established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission. Based on this assessment, management believes that, as of December 31, 2006, the Partnership maintained effective internal control over financial reporting.

The Partnership s independent registered public accounting firm has issued an attestation report on management s assessment of the Partnership s internal control over financial reporting. That report appears on page 53.

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors of Holly Logistic Services, L.L.C. and
Unitholders of Holly Energy Partners, L.P.

We have audited management s assessment, included in the accompanying managements report, that Holly Energy Partners, L.P. (the Partnership) maintained effective internal control over financial reporting as of December 31 2006, based on criteria established in Internal Control Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission (the COSO criteria). The Partnership s management is responsible for maintaining effective internal control over financial reporting and for its assessment of the effectiveness of internal control over financial reporting. Our responsibility is to express an opinion on management s assessment and an opinion on the effectiveness of the partnership s internal control over financial reporting based on our audit.

We conducted our audit in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether effective internal control over financial reporting was maintained in all material respects. Our audit included obtaining an understanding of internal control over financial reporting, evaluating management s assessment, testing and evaluating the design and operating effectiveness of internal control, and performing such other procedures as we considered necessary in the circumstances. We believe that our audit provides a reasonable basis for our opinion.

A company s internal control over financial reporting is a process designed to provide reasonable assurance regarding the reliability of financial reporting and the preparation of financial statements for external purposes in accordance with generally accepted accounting principles. A company s internal control over financial reporting includes those policies and procedures that (1) pertain to the maintenance of records that, in reasonable detail, accurately and fairly reflect the transactions and dispositions of the assets of the company; (2) provide reasonable assurance that transactions are recorded as necessary to permit preparation of financial statements in accordance with generally accepted accounting principles, and that receipts and expenditures of the company are being made only in accordance with authorizations of management and directors of the company; and (3) provide reasonable assurance regarding prevention or timely detection of unauthorized acquisition, use, or disposition of the company s assets that could have a material effect on the financial statements.

Because of its inherent limitations, internal control over financial reporting may not prevent or detect misstatements. Also, projections of any evaluation of effectiveness to future periods are subject to the risk that controls may become inadequate because of changes in conditions, or that the degree of compliance with the policies or procedures may deteriorate.

In our opinion, management s assessment that the Partnership maintained effective internal control over financial reporting as of December 31, 2006, is fairly stated, in all material respects, based on the COSO criteria. Also, in our opinion, the Partnership maintained, in all material respects, effective internal control over financial reporting as of December 31, 2006, based on the COSO criteria**.**

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the consolidated balance sheets of Holly Energy Partners, L.P. as of December 31, 2006 and 2005, and the related consolidated statements of income, Partners equity (deficit), and cash flows for the years ended December 31, 2006 and 2005 (successor), the period from July 13, 2004 through December 31, 2004 (successor), and the period from January 1, 2004 through July 12, 2004 (predecessor), of Holly Energy Partners, L.P. and our report dated February 22, 2007, expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP
Dallas, Texas
February 22, 2007

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The Board of Directors of Holly Logistic Services, L.L.C. and
Unitholders of Holly Energy Partners, L.P.

We have audited the accompanying consolidated balance sheets of Holly Energy Partners, L.P. (the Partnership) as of December 31, 2006 and 2005, and the related consolidated statements of income, partners equity (deficit), and cash flows for the years ended December 31, 2006 and 2005 (successor), the period from July 13, 2004 through December 31, 2004 (successor), and the period from January 1, 2004 through July 12, 2004 (predecessor). These financial statements are the responsibility of the Partnership s management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

As described in Note 6 to the consolidated financial statements, in 2005 the Partnership adopted Statement of Financial Accounting Standard No. 123(r), Share-Based Payments.

In our opinion, the consolidated financial statements referred to above present fairly, in all material respects, the consolidated financial position of Holly Energy Partners, L.P. at December 31, 2006 and 2005, and the related consolidated results of its operations and its cash flows, for the years ended December 31, 2006 and 2005 (successor), the period from July 13, 2004 through December 31, 2004 (successor), and the period from January 1, 2004 through July 12, 2004 (predecessor), in conformity with U.S. generally accepted accounting principles.

We also have audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the effectiveness of Holly Energy Partners, L.P. s internal control over financial reporting as of December 31, 2006, based on criteria established in Internal Control-Integrated Framework issued by the Committee of Sponsoring Organizations of the Treadway Commission and our report dated February 22, 2007 expressed an unqualified opinion thereon.

/s/ ERNST & YOUNG LLP
Dallas, Texas
February 22, 2007

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Holly Energy Partners, L.P.
Consolidated Balance Sheets

	December 31, 2006	December 31, 2005
	(In thousands, except unit data)	
ASSETS		
Current assets:		
Cash and cash equivalents	$ 11,555	$ 20,583
Accounts receivable:		
Trade	7,339	3,076
Affiliates	3,518	3,645
	10,857	6,721
Prepaid and other current assets	1,212	1,401
Total current assets	23,624	28,705
Properties and equipment, net	160,484	162,298
Transportation agreements, net	56,821	60,903
Other assets	2,644	2,869
Total assets	$ 243,573	$ 254,775
LIABILITIES AND PARTNERS EQUITY		
Current liabilities:		
Accounts payable	$ 3,781	$ 3,020
Accrued interest	2,941	2,892
Deferred revenue	5,486	1,013
Accrued property taxes	868	1,013
Other current liabilities	1,098	1,313
Total current liabilities	14,174	9,251
Commitments and contingencies		
Long-term debt	180,660	180,737
Other long-term liabilities	1,550	974
Minority interest	10,963	11,753
Partners equity (deficit):		
Common unitholders (8,170,000 units issued and outstanding at December 31, 2006 and 2005)	176,844	184,568
Subordinated unitholders (7,000,000 units issued and outstanding at December 31, 2006 and 2005)	(70,022)	(63,153)
	23,469	24,388

Class B subordinated unitholders (937,500 units issued and outstanding at December 31, 2006 and 2005)		
General partner interest (2% interest)	(94,065)	(93,743)
Total partners equity	36,226	52,060
Total liabilities and partners equity	$ 243,573	$ 254,775

See accompanying notes.

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Holly Energy Partners, L.P.
Consolidated Statements of Income

	Successor			Predecessor
	Year Ended December 31, 2006	Year Ended December 31, 2005	July 13, 2004 through December 31, 2004	January 1, 2004 through July 12, 2004
	(In thousands, except per unit data)			
Revenues:				
Affiliates	$ 52,878	$ 44,184	$ 17,917	$ 27,429
Third parties	36,316	35,936	10,265	12,155
	89,194	80,120	28,182	39,584
Operating costs and expenses:				
Operations	28,630	25,332	10,104	13,537
Depreciation and amortization	15,330	14,201	3,241	3,983
General and administrative	4,854	4,047	1,859	1
	48,814	43,580	15,204	17,521
Operating income	40,380	36,540	12,978	22,063
Other income (expense):				
Interest income	899	649	65	79
Interest expense	(13,056)	(9,633)	(697)	
	(12,157)	(8,984)	(632)	79
Income before minority interest	28,223	27,556	12,346	22,142
Minority interest in Rio Grande Pipeline Company	(680)	(740)	(956)	(1,038)
Net income	27,543	26,816	11,390	21,104
Less:				
Net income attributable to Predecessor				21,104
General partner interest in net income	1,710	721	228	

Limited partners interest in net income	$	25,833	$	26,095	$	11,162	$
Net income per limited partners unit - basic and diluted	$	1.60	$	1.70	$	0.80	$
Weighted average limited partners units outstanding		16,108		15,356		14,000	

See accompanying notes.

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

	Successor			Predecessor
	Year Ended December 31, 2006	Year Ended December 31, 2005	July 13, 2004 through December 31, 2004	January 1, 2004 through July 12, 2004
	(In thousands)			
Cash flows from operating activities				
Net income	$ 27,543	$ 26,816	$ 11,390	$ 21,104
Adjustments to reconcile net income to net cash provided by operating activities:				
Depreciation and amortization	15,330	14,201	3,241	3,983
Minority interest in Rio Grande Pipeline Company	680	740	956	1,038
Amortization of restricted units	927	207	30	
(Increase) decrease in current assets:				
Accounts receivable	(4,263)	(2,338)	(7)	(95)
Accounts receivable affiliates	127	(1,594)	(2,052)	(21,544)
Prepaid and other current assets	115	(1,499)	(323)	(44)
Increase (decrease) in current liabilities:				
Accounts payable	761	1,305	1,377	(1,293)
Accounts payable affiliates				(2,506)
Accrued interest	49	2,840		
Deferred revenue	4,473	1,013	51	
Accrued property tax	(144)	700	(67)	(72)
Other current liabilities	(215)	(20)	789	(74)
Other, net	470	257	(14)	(1)
Net cash provided by operating activities	45,853	42,628	15,371	496
Cash flows from investing activities				
Additions to properties and equipment	(9,107)	(3,883)	(305)	(2,672)
Acquisitions of pipeline and terminal assets		(127,912)		
Net cash used for investing activities	(9,107)	(131,795)	(305)	(2,672)
Cash flows from financing activities				
Proceeds from issuance of senior notes, net of discounts		181,238		
Proceeds from issuance of common units, net of underwriter discount		45,100	145,460	

Distributions to Holly concurrent with initial public offering			(125,612)	
Excess purchase price over contributed basis of intermediate pipelines		(71,850)		
Distributions to partners	(43,670)	(35,022)	(6,214)	
Borrowings (payback) of short-term of debt affiliates			(30,082)	
Borrowings (payback) under revolving credit agreement		(25,000)	25,000	
Costs of issuing common units		(349)	(3,486)	
Deferred debt issuance costs		(1,228)	(2,086)	
Cash distributions to minority interest	(1,470)	(2,220)	(987)	(2,250)
Cash contribution from general partner		612		
Purchase of units for restricted grants	(634)	(635)	(223)	
Net cash provided by (used for) financing activities	(45,774)	90,646	1,770	(2,250)
Cash and cash equivalents				
Increase (decrease) for the period	(9,028)	1,479	16,836	(4,426)
Beginning of period	20,583	19,104	2,268	6,694
End of period	$ 11,555	$ 20,583	$ 19,104	$ 2,268

See accompanying notes.

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Holly Energy Partners, L.P.
Consolidated Statements of Partners Equity (Deficit)

		Successor				
	Predecessor Parent	Common Units	Subordinated Units	Class B Subordinated Units	General Partner Interest	Total
			(In thousands)			
Predecessor:						
Balance December 31, 2003	$ 68,860	$	$	$	$	$ 68,860
Assets and liabilities not contributed to Holly Energy Partners, L.P.	(49,782)					(49,782)
Net income	21,104					21,104
Balance July 12, 2004	40,182					40,182
Successor:						
Allocation of net parent investment to unitholders	(40,182)		38,606		1,576	
Proceeds from initial public offering, net of underwriter discount		145,460				145,460
Costs of issuing common units		(3,486)				(3,486)
Distributions to partners		(3,045)	(103,657)		(25,124)	(131,826)
Purchase of units for restricted grants		(222)				(222)
Amortization of restricted units		30				30
Net income		5,581	5,581		228	11,390
Balance December 31, 2004		144,318	(59,470)		(23,320)	61,528
Issuance of common units		45,100				45,100
Cost of issuing common units		(349)				(349)
Issuance of Class B subordinated units				24,674		24,674
Capital contribution					1,591	1,591
Distributions to partners		(16,945)	(15,575)	(1,617)	(885)	(35,022)
Excess purchase price over contributed basis of intermediate pipelines					(71,850)	(71,850)

Purchase of units for restricted grants		(635)								(635)
Amortization of restricted units		207								207
Net income		12,872		11,892		1,331		721		26,816
Balance December 31, 2005		184,568		(63,153)		24,388		(93,743)		52,060
Distributions to partners		(21,120)		(18,095)		(2,423)		(2,032)		(43,670)
Purchase of units for restricted grants		(634)								(634)
Amortization of restricted units		927								927
Net income		13,103		11,226		1,504		1,710		27,543
Balance December 31, 2006	$	$ 176,844	$	(70,022)	$	23,469		$ (94,065)	$	36,226

See accompanying notes.

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NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
December 31, 2006

Note 1: Description of Business and Summary of Significant Accounting Policies

Description of Business

Holly Energy Partners, L.P. (HEP) together with its consolidated subsidiaries, is a publicly held master limited partnership, currently 45% owned by Holly Corporation (Holly). HEP commenced operations July 13, 2004. Concurrently with the completion of its initial public offering, Navajo Pipeline Co., L.P. (Predecessor) (NPL) and its affiliates, a wholly owned subsidiary of Holly, contributed a substantial portion of its assets to HEP. In this document, the words we , our , ours and us refer to HEP and NPL collectively unless the context otherwise indicates. See Note for a further description of these transactions.

NPL constitutes HEP s predecessor. The transfer of ownership of assets from NPL to HEP represented a reorganization of entities under common control and was recorded at NPL s historical cost. Accordingly, our financial statements include the historical results of operations of NPL prior to the transfer to HEP.

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 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. In conjunction with Holly s operation of the Navajo Refinery, 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 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.

Principles of Consolidation

The consolidated financial statements include our accounts and those of our subsidiaries. All significant inter-company transactions and balances have been eliminated. The consolidated financial statements include the financial position and results of operations of pipeline and terminal facilities previously owned by Holly and/or NPL, which were contributed to HEP concurrently with the completion of our initial public offering, as well as the intermediate pipeline assets that were purchased from Holly in July 2005. Both of these acquisitions of assets from Holly were accounted for as transactions among entities under common control. Therefore, the assets were recorded on our balance sheets at Holly s basis instead of the purchase price or fair value.

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If the assets acquired from Holly upon formation and the intermediate pipelines transaction had been acquired from third parties, the cash payment upon formation and the excess of the intermediate pipeline purchase price over its basis would have been recorded as properties or intangible assets instead of reductions of partners equity. Also, the subordinated units issued to Holly would have been recorded at fair value instead of the carryover basis of the contributed assets.

The consolidated financial statements also include financial data, at historical cost, related to the assets owned by Holly and its wholly-owned subsidiaries through July 12, 2004, other than HEP, that were not contributed to us upon completion of our initial public offering.

On June 30, 2003, we acquired an additional 45% partnership interest in Rio Grande, bringing our ownership to 70%. Commencing July 1, 2003, the results of Rio Grande were consolidated and reflected in our consolidated financial statements.

Use of Estimates

The preparation of financial statements in accordance with U.S. generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates.

Cash and Cash Equivalents

For purposes of the statements of cash flows, we consider all highly liquid investments with maturity of three months or less at the time of purchase to be cash equivalents. The carrying amounts reported on the balance sheet approximate fair value due to the short-term maturity of these instruments.

Accounts Receivable

The majority of the accounts receivable are due from affiliates of Holly or independent companies in the petroleum industry. Credit is extended based on evaluation of the customer s financial condition and, in certain circumstances, collateral such as letters of credit or guarantees, may be required. Credit losses are charged to income when accounts are deemed uncollectible and historically have been minimal.

Inventories

Inventories consisting of materials and supplies used for operations are stated at the lower of cost, using the average cost method, or market and are shown under prepaid and other current assets in our consolidated balance sheets.

Properties and Equipment

Properties and equipment are stated at cost. Depreciation is provided by the straight-line method over the estimated useful lives of the assets; primarily 10 to 16 years for pipeline and terminal facilities, 23 to 33 years for regulated pipelines and 3 to 10 years for corporate and other assets. Maintenance, repairs and major replacements are generally expensed as incurred. Costs of replacements constituting improvement are capitalized.

Transportation Agreements

The transportation agreement assets are stated at cost and are being amortized over the periods of the agreements using the straight-line method.

Long-Lived Assets

We evaluate long-lived assets, including intangible assets, for potential impairment by identifying whether indicators of impairment exist and, if so, assessing whether the long-lived assets are recoverable from estimated future undiscounted cash flows. The actual amount of impairment loss, if any, to be recorded is equal to the amount by which a long-lived asset s carrying value exceeds its fair value. No impairments of long-lived assets were recorded during the periods included in these financial statements.

Asset Retirement Obligations

We record legal obligations associated with the retirement of long-lived assets that result from the acquisition, construction, development and/or the normal operation of our long-lived assets. The fair value of the estimated cost to retire a tangible long-lived asset is recorded in the period in which the liability is incurred and when a reasonable estimate of the fair value of the liability can be made. If a reasonable estimate cannot be made at the time the liability is incurred, we record the liability when sufficient information is available to estimate the liability s fair value.

We have asset retirement obligations with respect to certain of our assets due to legal obligations to clean and/or dispose of various component parts at the time they are retired. At December 31, 2006, an asset retirement obligation of $0.3 million is included in Other long-term liabilities in our consolidated balance sheets.

Revenue Recognition

Revenues are recognized as products are shipped through our pipelines and terminals. Billings to customers for obligations under their quarterly minimum revenue commitments are recorded as deferred revenue liabilities if the customer has the right to receive future services for these billings. The revenue is recognized at the earlier of:

- the customer receives the future services provided by these billings,
- the period in which the customer is contractually allowed to receive the services expires, or
- we determine a high likelihood that we will not be required to provide services within the allowed period.

Additional pipeline transportation revenues result from an operating lease to a third party of an interest in the capacity of one of our pipelines.

Taxes billed and collected from our pipeline and terminal customers are recorded on a net basis with no effect on net income.

Environmental Costs

Environmental costs are expensed if they relate to an existing condition caused by past operations and do not contribute to current or future revenue generation. Liabilities are recorded when site restoration and environmental remediation, cleanup and other obligations are either known or considered probable and can be reasonably estimated. Environmental costs recoverable through insurance, indemnification arrangements or other sources are included in other assets to the extent such recoveries are considered probable.

Income Taxes

As a partnership, we are an entity that is not subject to income taxes. Therefore, there is no provision for income taxes included in our consolidated financial statements. Taxable income, gain, loss and deductions are allocated to the unitholders who are responsible for payment of any income taxes thereon.

Net income for financial statement purposes may differ significantly from taxable income reportable to unitholders as a result of differences between the tax bases and financial reporting bases of assets and liabilities and the taxable income allocation requirements under the partnership agreement. Individual unitholders have different investment bases depending upon the timing and price of acquisition of their partnership units. Furthermore, each unitholder s tax accounting, which is partially dependent upon the unitholder s tax position, differs from the accounting followed in the consolidated financial statements. Accordingly, the aggregate difference in the basis of our net assets for financial and tax reporting purposes cannot be readily determined because information regarding each unitholder s tax attributes in our partnership is not available to us.

Net Income per Limited Partners Unit

We have identified the general partner interest and the subordinated units as participating securities and use the two-class method when calculating the net income per unit applicable to limited partners, which is based on the weighted-average number of common and subordinated units outstanding during the year. Net income per unit applicable to limited partners (including subordinated units and Class B subordinated units) is computed by dividing limited partners interest in net income, after deducting the general partner s 2% interest and incentive distributions, and after deducting net income attributable to the Predecessor (before July 13, 2004), by the weighted-average number of units outstanding for each class of limited partners units.

Recent Accounting Pronouncements

Statement of Financial Accounting Standards (SFAS) No. 154 Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and FASB Statement No. 3

In May 2005, the Financial Accounting Standards Board (FASB) issued SFAS No. 154, Accounting Changes and Error Corrections a replacement of APB Opinion No. 20 and SFAS No. 3. This statement changes the requirements for accounting for and reporting a change in accounting principle and applies to all voluntary changes in accounting principles. It also applies to changes required by an accounting pronouncement in the unusual instance that the pronouncement does not include specific transition provisions. When a pronouncement includes specific transition provisions, those provisions should be followed. This statement requires retrospective application to prior periods financial statements of changes in accounting principle, unless it is impracticable to determine either the period-specific effects or the cumulative effect of the change. We adopted this standard effective January 1, 2006. The adoption of this standard did not have a material effect on our financial condition, results of operations and cash flows.

Interpretation No. 48 Accounting for Uncertainty in Income Taxes

In June 2006, the 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 derecognition, classification, interest and penalties, accounting in interim periods, disclosure and transition. This interpretation is effective for fiscal years beginning after December 15, 2006. We do not anticipate that the adoption of this interpretation will have a material effect on our financial condition, results of operations and cash flows.

SFAS No. 157 Fair Value Measurements

In September 2006, the FASB issued SFAS No. 157, Fair Value Measurements. This standard simplifies and codifies guidance on fair value measurements under generally accepted accounting principles. This standard defines fair value, establishes a framework for measuring fair value and prescribes expanded disclosures about fair value measurements. This standard is effective for fiscal years beginning after November 15, 2007. We do not anticipate that the adoption of this interpretation will have a material effect on our financial condition, results of operations and cash flows.

Note 2: Initial Public Offering of HEP

HEP was formed to acquire, own and operate substantially all of the refined product pipeline and terminalling assets that support Holly s refining and marketing operations in West Texas, New Mexico, Utah and Arizona and a 70% interest in Rio Grande.

On July 7, 2004, we priced 6,100,000 common units for the initial public offering; and on July 8, 2004, our common units began trading on the New York Stock Exchange under the symbol HEP. On July 13, 2004, we closed our initial public offering of 7,000,000 common units at a price of $22.25 per unit, which included a 900,000 unit over-allotment option that was exercised by the underwriters. Total proceeds from the sale of the units were $145.5 million, net of $10.3 million underwriting commissions. After the offering, Holly, through a subsidiary, owned a 51% interest in HEP, including the general partner interest. The initial public offering represented the sale of a 49% interest in HEP.
All of our initial assets were contributed by Holly and its subsidiaries in exchange for: (a) an aggregate of 7,000,000 subordinated units, representing 49% limited partner interests in HEP, (b) incentive distribution rights (as set forth in HEP s partnership agreement), (c) the 2% general partner interest, and (d) an aggregate cash distribution of $125.6 million.
The following table presents the assets and liabilities of our predecessor immediately prior to contributing assets to HEP, the assets and liabilities contributed to HEP, and the predecessor s assets and liabilities that were not contributed to HEP:

	Navajo Pipeline Co., L.P. (Predecessor) July 12, 2004	Contributed to Holly Energy Partners, L.P. July 13, 2004	Not Contributed
		(In thousands)	
Cash	$ 2,268	$ 2,268	$
Accounts receivable trade	850	800	50
Accounts receivable affiliates	51,934		51,934
Prepaid and other current assets	292	173	119
Properties and equipment, net	95,337	76,605	18,732
Transportation agreement, net	5,692	5,692	
Total assets	156,373	85,538	70,835
Accounts payable trade	1,452	339	1,113
Accounts payable affiliates	18,819		18,819
Accrued liabilities	1,018	534	484
Short-term debt	30,082	30,082	
Non-current liabilities	1,775	1,138	637
Minority interest	13,263	13,263	
Total liabilities	66,409	45,356	21,053
Net Assets	$ 89,964	$ 40,182	$ 49,782

We used the proceeds of the public offering and $25.0 million drawn under our credit facility agreement to: establish $9.9 million working capital for HEP, distribute $125.6 million to Holly, repay $30.1 million of short-term debt to Holly, pay $13.8 million underwriting commissions and other offering costs, and pay $1.4 million of deferred debt issuance costs related to the credit facility.
In connection with the offering, we entered into a 15-year pipelines and terminals agreement expiring 2019 with Holly and several of its subsidiaries (the Holly PTA) under which they agreed generally to transport or terminal volumes on

certain of our initial facilities that will result in funds to HEP that will equal or exceed a specified minimum revenue amount annually (which is currently $38.5 million and adjusts upward each year based on the producer price index (PPI)) over the term of the agreement. Under certain circumstances, generally dealing with Holly shutting down or reconfiguring its refineries, Holly s minimum revenue commitment to us could be reduced.

We also entered into an omnibus agreement with Holly and certain of its subsidiaries that became effective July 13, 2004 (the Omnibus Agreement) that specifies the services that Holly provides to us. Under the Omnibus Agreement, Holly charges us $2.0 million annually for general and administrative services that it provides, including but not limited to: executive, finance, legal, information technology and administrative services.

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Note 3: Acquisitions

Alon Transaction

On February 28, 2005, we acquired from 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.

The total consideration paid for these pipeline and terminal assets was $120.0 million in cash and 937,500 of our Class B subordinated units which, subject to certain conditions, will convert into an equal number of common units on February 28, 2010. We financed the Alon transaction with a portion of the proceeds of our private offering of $150.0 million principal amount of 6.25% Senior Notes due 2015 (see Note 7 for further information on the Senior Notes). In connection with the Alon transaction, we entered into a 15-year pipelines and terminals agreement with Alon expiring 2020 (the Alon PTA). Under this agreement, Alon agreed to transport on our pipelines and throughput in our terminals a volume of refined products that would result in minimum revenue levels each year that will change annually based on changes in the PPI, but will not decrease below the initial $20.2 million annual amount. Following the March 1, 2006 PPI adjustment, the volume commitments by Alon under the Alon PTA will produce at least $20.5 million of revenue for the twelve months ending February 28, 2007. The agreed upon tariffs will increase or decrease each year at a rate equal to the percentage change in the PPI, but not below the initial tariffs. Alon s minimum volume commitment was calculated based on 90% of Alon s then recent usage of these pipelines and terminals taking into account an expansion of Alon s Big Spring Refinery completed in February 2005. At revenue levels above 105% of the base revenue amount, as adjusted each year for changes in the PPI, Alon will receive an annual 50% discount on incremental revenues. Alon s obligations under the Alon PTA may be reduced or suspended under certain circumstances. We granted Alon a second mortgage on the pipelines and terminals acquired from Alon to secure certain of Alon s rights under the Alon PTA. Alon has a right of first refusal to purchase the pipelines and terminals if we decide to sell them in the future. 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, under which Alon, for a ten year term expiring in 2015, will indemnify us subject to a $100,000 deductible and a $20.0 million maximum liability cap.

The consideration for the Alon pipeline and terminal assets was allocated to the individual assets acquired based on their estimated fair values. The allocation of the consideration is based on an independent appraisal. The aggregate consideration amounted to $146.7 million, which consisted of $24.7 million fair value of our Class B subordinated units, $120.0 million in cash and $2.0 million of transaction costs. In accounting for this acquisition, we recorded pipeline and