06-Aug-2014

HollyFrontier Corp. (HFC)

Q2 2014 Earnings Call

CORPORATE PARTICIPANTS

Julia Heidenreich
Vice President-Investor Relations, HollyFrontier Corp.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

OTHER PARTICIPANTS

Doug Leggate
Analyst, Bank of America Merrill Lynch

Paul Cheng
Analyst, Barclays Capital, Inc.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Sam Margolin
Analyst, Cowen and Co. LLC

Paul Sankey
Analyst, Wolfe Research LLC

Edward G. Westlake
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Mohit Bhardwaj
Analyst, Citigroup Global Markets Inc. (Broker)

Manav Gupta
Analyst, Morgan Stanley & Co. LLC

Jeff A. Dietert
Analyst, Simmons & Co. International

MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the HollyFrontier Corporation's Second Quarter 2014 Conference Call and Webcast. Hosting the call today from HollyFrontier Corporation is Mike Jennings, President and Chief Executive Officer. He is joined by Doug Aron, Executive Vice President and Chief Financial Officer.

At this time, all participants have been placed in a listen-only mode and the floor will be open for your questions following the presentations. [Operator Instructions] Please note that this conference is being recorded.

It is now my pleasure to turn the floor over to Julia Heidenreich, Vice President, Investor Relations. Julia, you may begin.

Julia Heidenreich
Vice President-Investor Relations, HollyFrontier Corp.

Good morning, everyone, and welcome to HollyFrontier Corporation's second quarter earnings call. This morning we issued a press release announcing results for the quarter ending June 30, 2014. If you'd like a copy of today's release, you can find one on our website at www.hollyfrontier.com.

Before Mike and Doug proceed with their prepared remarks, please note the Safe Harbor disclosure statement in today's press release. In summary, it says statements made regarding management's expectations, judgments or predictions are forward-looking statements. These statements are intended to be covered under the Safe Harbor provisions of the federal securities laws. There are many factors that could cause results to differ from expectations, including those noted in our SEC filings.

Today's statements are not guarantees of future outcomes. Today's call may also include discussion of non-GAAP financial measures; please see the press release for reconciliations to GAAP financials. Also, please note that information presented on today's call speaks only as of today, August 6, 2014. Any time-sensitive information provided may no longer be accurate at the time of any webcast replay or re-reading of the transcript.

And with that, I'll turn the call over to Mike Jennings.

Michael C. Jennings

Chairman, President & Chief Executive Officer, HollyFrontier Corp.

Great. Thank you, Julia. Good morning. Thanks for joining us on HollyFrontier's second quarter earnings call. Today we reported second quarter net income attributable to HFC shareholders of $176 million or $0.89 per diluted share.

Our second quarter EBITDA was $388 million, which represented a 15% improvement over the first quarter EBITDA of $339 million. Improved refinery operations, attractive Midland crude differentials and good heavy crude economics during quarter helped to drive this result, which was influenced to the down side by weaker co-product cracks and backwardation in the crude market structure.

Our second quarter financial performance was also affected by some one-time items relating to non-cash write-downs that Doug will address in detail. These charges combined to reduce the quarterly EPS by about a dime.

Second quarter crude throughput was 439,000 barrels per day versus guidance of 425,000. We ran 23% sour and 18% WCS and black wax crude. Our average laid-in crude cost across refining system was $3.97 per barrel under WTI. Regionally, we experienced average laid-in differentials under TI as follows: $10.84 in the Rockies; $1.92 in the Mid-Con; and $4.59 in the Southwest.

Our consolidated refinery gross margin for the second quarter was $14.54 per produced barrel, slightly below the $14.75 of gross margin recorded in Q1 of 2014. On a regional basis, our second quarter gross margins per barrel ranged from a high of $17.49 in the Rockies to a low of $13.01 in the Mid-Con.

During the quarter, crude differentials generally moved against us with the exception of the Midland crudes. Inland, Coastal and Canadian heavy dips compressed 30% and 13%, respectively, pressuring our capture rates in the Rockies and Mid-Con regions.

Our Navajo Refinery ran very well through the second quarter, operating an average crude charge rate in excess of 100,000 barrels per day and capturing the full benefit of wide Midland Cushing spreads. The surplus crude in the Midland market has continued into the third quarter and we continue to realize attractive crude oil economics in the Permian. Much of this is being driven by production increases just outside our fence line in the Delaware Basin.

Permian Basin rig count grew 20% to over 500 rigs in the first six months of the year. During this time, there has been a significant reweighting towards horizontal rigs, which now account for 60% of total rig count.

In the Delaware, we're seeing increased well productivity and producers continue to revise production profiles higher. The Permian Basin is on track to account for a quarter of total U.S. crude production in the next decade.

We participate in this production growth not only through Navajo Refinery crude purchases, but also through our crude gathering and transmission business undertaken by Holly Energy Partners, our related MLP. HEP's expansion of its Southeastern New Mexico gathering system is nearly complete and we anticipate this expansion will increase our gathered crude volumes by up to 40,000 barrels per day in the near term with further growth achievable as we develop additional links to major market clearing points.

The crude market was significantly backwardated in the quarter by $0.93 per barrel on average, which negatively impacted both Southwest and Mid-Con margins, where the majority of the crude we purchase is priced on a calendar month average basis that includes the impact of the roll.

Softer co-product prices also pressured margins during the second quarter. With a combined asphalt and fuel oil yield of 8%, the Rockies region was most impacted by these second quarter co-product prices, with a nearly $2 per barrel negative contribution realized during the quarter. We've seen a significant improvement in the asphalt and fuel oil cracks in July across all regions relative to second quarter levels, which should lead to an improved margin captured during the third quarter.

Lost opportunity for the second quarter was around $38 million pre-tax, much of this attributable to power failures and subsequent mechanical problems at our Cheyenne and El Dorado facilities. For the third quarter, we expect to run 405,000 barrels per day of crude, with 17% of the slate being price advantaged heavy and waxy crudes and 23% sour crudes.

July indicator margins for our regions were a mixed bag. The Rockies market remained strong with WTI based 3:2:1 indicator improving nearly 15% compared to second quarter levels. The Mid-Con indicator margin declined during July to more than 20% below second quarter average levels. However, these Mid-Con margins have recently improved as WTI Cushing prices have eased along with other physical crude grades throughout the Inland U.S. and Canada.

Cushing inventories remain low on account of recently added pipeline capacity, though with Gulf Coast sweet crudes trading very near to WTI Cushing price, we believe the incremental flows to the Gulf Coast will need more of a price incentive in the form of a deeper Cushing discount to accommodate transportation and terminaling costs.

I also expect we will see a reshuffling of crude flows to Cushing and the Gulf Coast upon startup of Flanagan South, White Cliffs expansion and Pony Express pipelines scheduled to come online in late 2014 and early 2015 with a combined crude capacity of approximately 900,000 barrels a day of crude delivery potential into the Cushing market. For the rest of the year, our internal plans include a fourth quarter FCC Gulf liner and alkylation unit turnaround at El Dorado as well as one of our two Navajo crude units, a distillate hydrotreater and gas/oil hydrocracker, all at the Artesia facility.

From a macro perspective, the U.S. refining sector is strong and benefiting from internal investment and from less expensive fleet stocks and utility costs. There are, of course, some offsets that include the cost and uncertainty of bio-fuels mandates, and volatility within the crude markets, as differentials and market structure adjust to production increases and new logistics assets.

Gasoline demand is generally considered flat or slightly down, though month of May gasoline demand averaged over 9 million barrels per day for the first time in the four years. And consumer purchasers are moving back in the direction of SUVs and light trucks. We believe these fundamentals, the greatest of which is obviously the strong growth in U.S. crude production should create solid refined product margins as we go forward through 2014 and into 2015.

And with that, let me turn it over to Doug Aron, our Chief Financial Officer.

Douglas S. Aron

Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

Thanks, Mike. For the second quarter of 2014, cash flow provided by operations totaled $327 million. Second quarter capital expenditures totaled $102 million, excluding HEP's $18 million capital spend. Turnaround spending in the quarter totaled $5.4 million. We maintain our full year 2014 CapEx guidance of approximately $400 million and turnaround spending of $77 million.

Total refinery segment operating costs for the quarter totaled $237 million. As of June 30, 2014, our total cash and marketable securities balance stood at $1.8 billion, in line with our March 31 levels. HollyFrontier debt totaled $189 million, excluding non-recourse HEP debt of $839 million.

On July 1, we terminated our $1 billion senior secured credit agreement and replaced it with a new $1 billion senior unsecured revolving credit facility, which matures July 1 of 2019 to bring us in line with the standard for investment grade rated companies. The unsecured facility should save us approximately $1.7 million a year and give us additional flexibility.

HollyFrontier currently owns 39% of Holly Energy partners, including 22.4 million common units in the 2% GP interest. The current market value of our LP units is approximately $749 million as of last night's closing price. Second quarter general partner incentive distributions were $8.1 million. Through the first six months of the year we have received $39 million in cash distributions from HEP.

In the second quarter, we announced and paid a $0.32 regular and $0.50 special dividend, distributing $163.4 million to shareholders. Today, we also announced a $0.32 regular and $0.50 special dividend to be paid in the third quarter. Since our July 2011 merger, HollyFrontier has now returned approximately $2.4 billion in capital to shareholders through regular dividends, special dividends and share repurchases, including today's announcement.

As of June 30, we have $312 million, remaining under our share repurchase authorization. And as of today, our trailing 12 months, cash dividend yield stand at 7% relative to yesterday's closing price of $45.81.

During the quarter, we incurred $31 million of pre-tax charges relating to the write-down of several assets at our Navajo, Cheyenne, and Tulsa refineries. $7 million of that ran through the OpEx line and the rest through depreciation and amortization.

Lastly, a reminder that you can find monthly WTI based 321 indicators for our Mid-Con, Rockies and Southwest regions, posted on HollyFrontier's investor page. These regional indicators do not reflect actual sales data or are meant to show monthly trends. Realized gross margin per barrel may differ from indicators for a variety of reasons; you can find the data on our investor page at hollyfrontier.com.

And now, Stephanie, I believe we're ready to take questions.

QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Thank you. Our first question comes from Doug Leggate with Bank of America. Your line is open.

Doug Leggate
Analyst, Bank of America Merrill Lynch

Q

Thanks. Good morning everybody. Mike and Doug, I wonder if I could ask the dividend question in a slightly different way; gets asked every quarter I guess, but what are the other potential calls on cash as you look forward in terms of organic opportunities. I guess, an elevated oil price environment you've got different letters of credit requirements I guess, but when you look at more of the kind of planning base for your use of cash, what are the other calls on cash that could otherwise change your way on how you treat the special versus your ordinary dividend? Then, I've got a follow-up, please.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Sure. Doug, there are effectively two. The first is a promising project in Salt Lake City and Woods Cross that relates to conversion of waxy crudes into Group III or higher lubricants. And we are continuing to develop this project internally; we haven't got into a final investment decision point. But we believe it's a very high return project but also high cost in terms of capital. And so we're continuing to run that to ground in terms of initial engineering and commercial development with expected final investment decision sometime next year, middle of the year.

Second is new focus on share repurchase and that is something that, as you probably know or as we've said repeatedly, we debate and discuss every quarter and it's getting more internal interest and discussion at this point. We've had a long string of paying out a very high cash yield on our stock and we're continuing to do that this quarter. Obviously, we think it's benefited our shareholders to a great degree and we've seen a lot of other companies follow us in this. But share repurchase remains a large opportunity for us as well, particularly at these types of valuations.

Doug Leggate
Analyst, Bank of America Merrill Lynch

Q

Mike, just to be clear as a point of clarification, after three years that would be quite a big switch. Are you suggesting that you'll forgo the special for buybacks given where the stock is or that both are on the table?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

No, you asked I think what the additional cash calls on the stock might be.

Doug Leggate
Analyst, Bank of America Merrill Lynch

Q

Right.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

And so I highlighted those two. I'm not suggesting to forgo. But those are incrementally where we could invest cash for shareholder value.

Doug Leggate
Analyst, Bank of America Merrill Lynch

Q

Got it. Thank you. My follow up is a totally different question. Earlier this year, you made some changes obviously on the management of HEP. I'm just wondering how any – how that may have changed or may have changed the focus on additional initiatives that could resume growth in that part of the business? And I'll leave it there. Thanks.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Yeah. Look, we have a great management team in place at HEP and a lot of confidence in them. I'd say a solid half of their effort is targeted toward external growth right now, externally generated revenues and they highlight that in their quarterly discussions with every unit holders. But crude gathering in the Permian and generally logistic support in the Permian and some in the Rockies are their principal areas of focus, in addition to those investments which facilitate HFC's growth from a logistics perspective.

Doug Leggate
Analyst, Bank of America Merrill Lynch

Q

All right, Mike, I'll let someone else jump on. Thanks very much.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Thank you, Doug.

Operator: Our next question comes from the line of Paul Cheng with Barclays. Your line is open.

Paul Cheng
Analyst, Barclays Capital, Inc.

Q

Hey, guys. Good morning.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Hi, Paul.

Paul Cheng
Analyst, Barclays Capital, Inc.

Q

Before I ask my question, I just want to make a request. It's great that you guys gave the unit number and GP cash early in the call. But if possible that in the future if you can actually put it down in the press release, I think that would be really helpful for many of your investors.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Thank you, Paul.

Paul Cheng
Analyst, Barclays Capital, Inc.
Q

I guess that with the – there's a market rumor talking about CITGO, the refinery could be up for sale. Mike, can you maybe refresh our mind in terms of how you guys view on the M&A market or the opportunity there? How important or significant is that part of your strategy over the next, say, one or two years?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

We have a refining system that we have great confidence in. We're working hard to develop it to improve its reliability and improve the discounting crude feeds to our plant. So that is the heart of the fairway in terms of our strategy. Incrementally, acquisitions, CITGO could fit very well. It's obviously a large bite if it's actually for sale. But we look hard at all these types of opportunities, particularly those with an inland crude supply tributary and so CITGO would obviously fit that. But with that said, we're really focused on returns at this company. And to the extent that we feel like we can increase our share value by pursuing such an acquisition, we'll do so. And if the price point or the opportunity doesn't fit us, we're very happy with the assets that we have.

Paul Cheng
Analyst, Barclays Capital, Inc.
Q

Mike, is there any particular financial metrics in any M&A transaction that you will be focusing on that it needs to be accretive to the EPS or that you need to have a particular multiple? I mean, what kind of metrics that you maybe internally consider?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Yeah. Well, I mean, Paul, frankly, with our current balance sheet and abundance of cash, anything that we buy is accretive to EPS to some degree, I would assume. So it has to be a higher hurdle than that. Presumably, we're going to pay market value in any acquisition that we undertake and so we need to be able to add to that incrementally additional earnings through combination synergies, managing the assets better or a different view on the future. So that's really what we're looking for is how do we add incrementally to the value of the business that we would otherwise pay market value for.

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP
A

Paul, I would just add to that that given no debt on our balance sheet and the extraordinarily low cost of debt today, as Mike said, you could make accretion look very appealing. But if you look at our 20 plus year return on capital employed number of right at or just above 20%, that's a hurdle that we're proud of and one that as a management team we're compensated on, one that we'll continue to look at as needing to be able to return a healthy risk return for our shareholders. So it's not just accretion, it's certainly return on capital as well.

Paul Cheng
Analyst, Barclays Capital, Inc.
Q

Great. A final question from me; if I look at your Southwest system, your crude slate in the second quarter is quite dramatically different than your historical part. You run only 1% on the heavy sour; normally you run more like 8% to 10%. Is that just a function because the Midland differential is so wide this quarter or that this is really going to be the new slate because you changed the way how you're running it going forward?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Paul, the crude dynamic there is as follows. WCSs crude trading at WTI minus $6 to $8 at Cushing. And when we use that market price and compare it to our opportunity at the Navajo refinery, we find that we have much better crude economics by buying that local Midland barrel, which is discounted to the same degree or wider despite being a sweet crude barrel. So unless and until that inverts, I would expect the Navajo system to be running local crudes, Permian crudes, to the exclusion of WCS.

Paul Cheng
Analyst, Barclays Capital, Inc.

Q

Thank you.

Operator: Our next question comes from the line of Roger Read with Wells Fargo. Your line is open.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

Yeah, good morning. I guess, just one other question along the lines of the rumors out there about CITGO. As you talk about the 20% ROCE long term, what really is kind of the hurdle rate? I mean, I understand 20% is something you're proud of and would want to maintain, but if you return 15% we'd generally be happy. So can you kind of help us understand maybe what your own sort of minimum expectations would be in an acquisition or investment there?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

We're certainly looking for happy shareholders, Roger, so I guess 15% may be the number. But in fact, we don't have a hard hurdle rate around an acquisition opportunity. We obviously look at return on capital employed hard, we look at what we believe our cost of equity and weighted average costs of capital are. And for our internal investments, we expect to double those returns in the capital that we put to work within our plants. And that's, among other things, to cushion for lack of visibility of the forward margins.

As it relates to an acquisition, I can't give you the secret sauce because I don't have it. But I do know that in a competitive process, you're going to pay about market value for these assets and if you can't add to them through different management or a combination with your own existing assets, there has been effectively zero uplift in what you've purchased. So that's as much guidance as I can give you.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

Okay. No, that's helpful. And then, any possibility that you can go into more detail about the opportunities in West Texas? You mentioned some of them in the preview part here, 40,000 barrels a day in the near term, more behind that. At one point there was talk of a rail option out in that area; just wondering if you could give us maybe a little bit more granularity on what is possible out there, I mean is rail back on the table, yes, no, maybe? Is the rest of it conventional pipelines? We continue to see the area of drilling expand out there, maybe kind of give us an idea of where your stronger areas might be for future growth?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Sure. The Delaware Basin is our home court in terms of further developing our gathering and transmission infrastructure, and traditionally that gathering system served the Navajo refinery. We've obviously come to the conclusion that we need to be able to gather crude and get it to market, in addition to consume it ourselves, in order to provide a value-added service to the producers. And so next phase is more extensions to the existing gathering system, but also linking that system into transmission points where the crude can get to the Gulf Coast and Cushing, and that affords us the growth beyond our refining appetite to be able to gather effectively more than we can distill.

That, I would say, is our greatest opportunity, because of our established infrastructure and competitive position out there. Rail is not presently on the table, though our Lovington facility has very good rail access and the economics of developing that would be as good as anywhere. In our view, putting a rail system in place requires a continued view of Permian differentials inside Cushing of probably $8 to $10 and that's – the question is whether the shipper is going to make that commitment to the facility or whether we do on speculation. Thus far we have not speculated.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

I appreciate that, just one last follow-up there on Navajo, is it receiving all of its crude by pipeline, are you getting crude in by truck or by rail at this point from the Permian area?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

It's principally by pipeline through our gathering system. We run crude trucks out in the Permian, largely to feed the gathering system.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

Okay, that's helpful. Great, thank you.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Okay.

Operator: Our next question comes from the line of Sam Margolin with Cowen and Company. Your line is open.

Sam Margolin
Analyst, Cowen and Co. LLC

Q

Good morning. I wanted to circle back to those – to that write-down. It sounds like from the language of the press release, it was more focused on sort of ancillary infrastructure, maybe not core refining units. But if we could just get a little more color on that, that would be great.

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

A

Yeah, sure. Sam, what I would tell you is, there were – it was a list of few different things, and – excuse me, in Cheyenne, we had a disposal well that we drilled in order to try and send waste water down it. As it turns out, after we got to the water table, thought we were in area, because there was another company that it drilled very near there, that we could put water down hole. Turns out, we couldn't because it was drinking water. So that was $6.5 million or closer to $7 million of OpEx for Cheyenne in the quarter.

In Tulsa, we had some units around treating of gasoline that we found better technology and replaced it with what I would call newer and better operating units that would lead to less OpEx in the future, perhaps, and so took idle assets out of place. There were several like that in Tulsa, and then a couple of in Navajo, which totaled that sort of $25 million of DD&A.

Sam Margolin
Analyst, Cowen and Co. LLC

Q

Okay. Great. Thank you so much. And then just one more on the Delaware Basin initiatives; I wonder, first of all, if you could just remind us on the exit rate gathering volumes, if it actually exceeds Navajo when you're looking at third party sales as well. And also in light of the condensate permits, it sounds like you guys have a really close eye on everything from the upstream angle in the area, with your discussion about the recent type curve moves. But if you've seen any broader API progressions up and if you might also consider maybe some splitters or other assets that could position you, and HEP down the road, to maybe take advantage of not necessarily changing legislation but more, I guess, solid guidance from the BIS about what the specs are?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

That's a mouthful. Okay, I'll try. First off, on your question, I think you're asking about gathering volumes, growth in that, and whether we need to have exit capacity in order to gather where we are today. The answer is, today, our gathering volumes are inside of our crude appetite. But as the – what HEP refers to as the Malaga system, our Southeast Mexico new gathering extension, that additional up to 40,000 barrels a day will definitely push us over where we can consume that at the refinery, particularly when one considers refinery turnarounds and then things such as that. So that's – thus the need to get connected into transmission infrastructure, to get those barrels to Gulf Coast or to Cushing and be a reliable gatherer for our producers. Today, gathered volumes are in the 50,000 barrels to 60,000 barrels range, versus crude distillation of approximately 100,000 barrels.

Moving beyond that, your question I think was relative to the light crude and condensates in particular; does investment in condensate splitting make sense for us. And the answer to that question really depends upon logistics infrastructure to move condensate from the very light ends, from West Texas or New Mexico, in fact, to the Gulf Coast. Obviously, there's not much of a market locally in Southeast New Mexico for the light condensate. And so we've concluded that railing that material is a fairly expensive long term proposition, probably $10 a barrel to move that to the Gulf Coast. So condensate splitting in West Texas, in our view, will depend upon transmission infrastructure to a market that values the light product. That hasn't happened yet, but there is discussion of such a line so that's one that we're sort of watching. And then the question is really where is it most economic to split that condensate.

On the crude exports front, as a consumer and manufacturer of crude oil we are not supporters of crude exportability. We think that it's one piece in a puzzle of U.S. energy policy, and then that one piece by itself shouldn't be addressed; that the RFS and other items should be addressed along with. And with that said, we're great supporters of free markets. We think that it creates wealth for all of us. It's just that we don't believe addressing crude exports in isolation makes sense.

So what happens at BIS and how they move, I think they made a strong move relative to the Pioneer and Enterprise decision and have since retrenched and gotten a lot of negative feedback from the elected officials. So we're just going to have to see that how that goes. I don't think I have a great policy inside other than to watch it and read it much as you are.

Sam Margolin
Analyst, Cowen and Co. LLC

Q

Okay. Thanks so much. Appreciate it.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Okay.

Operator: Our next question comes from the line of Paul Sankey with Wolfe. Your line is open.

Paul Sankey
Analyst, Wolfe Research LLC

Q

Hi. Good morning, everyone.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Hi, Paul.

Paul Sankey
Analyst, Wolfe Research LLC

Q

Can you talk a bit about demand? I think that there were some issues with distillate, obviously, in the quarter and pricing there. Could you just give us your latest thoughts? Thanks.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Yeah. And distillate is the key product in terms of the U.S. crude complex. I don't think any – pardon me, refining complex, I don't think anybody sees great gasoline demand growth in the near-term and there was a swoon during the quarter and in cracks and then probably demand. I think it's mostly related to export loadings off the Gulf Coast and how much Russian and Persian Gulf distillate is moving to Europe. It's obviously a global market now. I don't know that there has been any real compression in demand for diesel, though I do know that the new over the road engines on the truck fleet are substantially improved in terms of their efficiency.

So when we see diesel cracks come into the level of gasoline cracks or inside that, we have some concern. That has since changed and refiners, I think, are probably taking action in terms of product slates and crude throughput even in response to the margin activity that occurred during the month of July. So what I'd tell you is that we're watching it. We don't think that the story is different, but obviously for a period of three weeks or four weeks at least, it caught our attention.

Paul Sankey
Analyst, Wolfe Research LLC
Q

Are things better now?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Yes.

Paul Sankey
Analyst, Wolfe Research LLC
Q

That's a simple answer. Thank you. If you could continue the thought into where you see us in the cycle and I know, it's an almost impossible question, but I guess, what I'm driving at is two things: firstly, your hedging strategy; in the past, you've been quite openly prepared to lock in when you think things are overstretched in either direction. And then secondly, your acquisition strategy; you stood out as the refiners that bought refining when we were at the bottom of the cycle. I would imagine that at the current point, you would be less interested in doing deals just because my best guess is that we're somewhere around mid-cycle right now. Thanks, Mike.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Sure. Well, so as to where we are in the cycle, I'll steal from Doug, whom I think is pretty clever but he says, well, if we're in the eighth inning, it's a double-header, and I think that's pretty accurate. That matches up well with your thought around mid-point in this cycle. I believe that current margins, current demand reflect that. We have not seen much of an increase yet in light products demand in the United States, though the economy is definitely improving. And the residential real estate home building market is improving; that's a big driver of gasoline demand to job site type activity. And employment is improving. Not unemployment rate, but actual job numbers are going up, so we're pretty bullish about that.

Offsetting, you've obliviously got a lot of volatility, induced by geopolitical events, and that, I think, scares everybody. It's certainly scared the market over the past few days. But does that sidetrack where we are in terms of cycle for petroleum product demand in the United States and globally? And it's not clear to me that it does. The producers are doing very well in terms of growing production, increasing efficiency.

This is significantly a U.S. versus the world crude oil story. Our sector of this business is monetizing that in to a saleable refined product that can travel. And I think that's the role we play. We need to look to international demand in order to make conclusions about where we are in the cycle.

As to our own company's acquisition strategy, I'd say that things are neither cheap nor expensive right now. They seem sort of in the middle. I wouldn't feel as though we were stealing something if we bought in this current environment, but it also doesn't feel toppy to me.

Paul Sankey
Analyst, Wolfe Research LLC
Q

Great. Was there anything to add on hedging strategy? Thanks.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Doug, go ahead.

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

A

Paul, what I would say is ordinarily I think and in most cases folks buy HFC shares because they want o exposure to crack spread. And in our typical hedging strategy, historically, when we see what we see or when we see what we see is extraordinary or very top-end of a 5-year or 7-year or 10-year range, and we get a chance to lock some of that in, it's probably prudent to do so. Otherwise if, using your term, it feels more like mid-cycle, I'm not sure as a management team we would be creating much value by locking that in. We certainly don't have an interest expense burden that we need to worry about or other reasons why folks typically hedge. So only when we see prices as being extraordinary do we typically hedge.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Yeah. We measure that as a two standard deviation from historical average, and we can always debate what history is. But that gives you feel for where we like to hedge, and we're not there right now.

Paul Sankey
Analyst, Wolfe Research LLC

Q

Thank you, guys.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Yep.

Operator: Our next question comes from the line of Ed Westlake with Credit Suisse. Your line is open.

Edward G. Westlake
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Hey, yes, good morning. A couple of quick ones. Your guidance I think for third quarter for throughput was I think you said 405,000 barrels per day, which looks a bit less than the second quarter. So I'm just – if I got that right, any color on where that drop off is being driven from?

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

A

Yeah. Three things really, the first of which is that we have some planned maintenance going on in the third quarter. The El Dorado large turnaround of the FCC will commence toward the end of this quarter. We also have had some unplanned maintenance at particularly El Dorado and Cheyenne, which affected crude throughput during the quarter already. And finally, as we looked at Mid-continent gasoline margins in the month of July and saw $5 crack spreads, our conclusion about how much crude to run in that sector was affected so we're toning that down a bit. So the combination of those three items really represents the difference between second quarter and third quarter.

Edward G. Westlake
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

And then on the logistics side, I mean outside of HEP, maybe you could give us a little bit of color of how much Holly is actually spending in terms of CapEx on logistics in 2014, and maybe how that might change based on the opportunity sets. I appreciate some of these things in the Uinta and stuff is probably still work in progress, but how that might change in 2015?

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

A

Right. So our CapEx spent on logistics is nearly 100% executed through HEP, and we then engage through TND commitments to HEP. HFC is not building in warehousing logistics assets at present. Whether we take – make commitments to third parties for additional logistics capacity really depends on the individual opportunity, and I'm not prepared to discuss those. But really it's not a focus for HFC CapEx.

Edward G. Westlake
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

Okay, thank you, very clear. Just on – then a macro question; I mean obviously in the Southwest everyone's benefiting from this wide TI/Brent spread. I mean, you guys are probably going to be as close to it as anyone. There are worries that BridgeTex, one of the pipes, would narrow that spread when it starts up later in this quarter, but then as a counterpoint to that, some folks suggest that the connections into Colorado City are perhaps not yet ready and therefore it's going to be trucked volumes. So just wondering if you had any perspective on how that ramp up might affect the wide spreads that we're seeing at the moment in the Midland?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Well, I think you've pretty well characterized it. BridgeTex throughput potential is 300,000 barrels a day. I think in the press we've read that the ability to get that amount of crude to the Colorado City injection point is limited or nil right now. And so they're really dependent upon trucking. That will change over time, of course; pipe is being put in the ground. But as a near term threat to run 300,000 barrels a day beginning September, I would discount that heavily. And on the flip side of that is obviously the growth in the Permian, which feels like a pace of 200,000 a day year-over-year.

So as each of these pieces of logistics infrastructure come on, as I referenced in my opening comments, there's a reshuffling. And sometimes it's painful and it causes you to question your underlying assumptions. But crude growth is the driver. And we're fairly confident, based upon comments from our customers and discussions with them that growth in the Permian has very long legs. So I think BridgeTex is an important piece of infrastructure, but it's not determinative long term about Midland versus Cushing or Gulf Coast differentials.

Edward G. Westlake
Analyst, Credit Suisse Securities (USA) LLC (Broker)

Q

One final small one. Any crude discounts emerging say versus Cushing WTI in the Tulsa region, just as domestic production kicks off in that sort of Mid-Con area?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Those aren't significant. There's a little bit of money to be made or discount to be gathered through gathering by truck into the Tulsa facility. But Tulsa is very close to Cushing, and there's a lot of pipe in the ground in Oklahoma. So I wouldn't tell you that we expect wide Tulsa/Cushing differentials going forward.

Edward G. Westlake
Analyst, Credit Suisse Securities (USA) LLC (Broker)
Q

Thanks.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Yeah.

Operator: Our next question comes from the line of Mohit Bhardwaj with Citigroup. Your line is open.

Mohit Bhardwaj
Analyst, Citigroup Global Markets Inc. (Broker)
Q

Yeah. Thanks for taking my question. Doug, I just wanted to follow up on the earlier question regarding hedging. So I think a lot of your comments were on the product side, but you still have the hedges in place on the WCS side, I would assume, as you have in the past. If you could just clarify that for us?

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP
A

Sure. And yeah, I think Paul's question was more geared toward product hedges; at least that's the way I understood it. You are correct. When we see an opportunity, really more to lock in a supply agreement perhaps with a Canadian producer or for that matter a bank that's going to sell it forward, there is a certain amount of Canadian heavy crude that fits very well into our Mid-Continent, in particular, El Dorado and then Cheyenne refineries.

And so when we see something in the low 20s on some volume we think it makes some sense to lock that supply up and guard against perhaps new pipelines or other opportunities. I would say that spread seems to be widening in the near term, but that's something we'll continue to pursue I think in the low 20s. The other one that is probably worth mentioning has been natural gas. We do have some hedges on the books for three or four more years with natural gas in the high 3s or low 4s. Again, big feedstock for us and one where we see that as price protection.

Mohit Bhardwaj
Analyst, Citigroup Global Markets Inc. (Broker)
Q

And Doug, if you could just clarify the – you enter crude purchases as well. I think in the past you have mentioned that TI, 80% of that, somewhere around that, and you have a term contract as well. Is that how it works, or is there hedges in place for that as well?

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP
A

Yeah. We have a confidentiality agreement in place with Newfield around the 10-year supply agreement with them. What we can say is that it approximates an historical average, and your number is very close to being right. It's about 80% of WTI and then we have about $5 of transportation from the basin down to the Salt Lake City refinery, so lands into the refinery at $100 crude at about $15 off.

Mohit Bhardwaj
Analyst, Citigroup Global Markets Inc. (Broker)
Q

Okay. And Mike, if I could just ask one final one, a lot of your peers have followed this whole diversification strategy in terms of where the cash flow streams are coming from, and you obviously have the logistics side of the assets. And in the beginning of the call, you also mentioned the project at Woods Cross. Is there any opportunity for you guys to get involved on the condensate side, you mentioned that, and also on the chemical side, as some of your peers are doing? If you just clarify that for us?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Yeah. Our focus really is around lubricants. We have a very solid Group I lubes business in the Tulsa marketplace, and what I believe are pretty strong capabilities in lubricants marketing. So our view is that pushing that through converting waxy crudes to lubes is synergistic with our existing capability, and the economics of that physical process appear to be pretty attractive, so that's sort of where we're pointing the gun right now. There are obvious opportunities in the logistics space any time you have crude production growth and we participate in that through HEP. As I said previously, HFC is not intending to make significant logistics investments; we would do that through our MLP subsidiary for cost of capital reasons.

Getting to chemicals, that really is beyond the scope of where we play. So I'd really point you towards lubricants and crude gathering as those things apart from fuels production that we're most likely to participate in.

Mohit Bhardwaj
Analyst, Citigroup Global Markets Inc. (Broker)
Q

Thanks for your comments.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Yeah.

Operator: Our last question comes from the line of Evan Calio with Morgan Stanley. Your line is open.

Manav Gupta
Analyst, Morgan Stanley & Co. LLC
Q

Hi, guys, this is Manav Gupta today. A couple of quick questions. First, following up on Ed's question, what is the plant turnaround activity looking for the fourth quarter, what are the plant turnarounds right now that you have already announced for the fourth quarter?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.
A

Give us one second on that one. Maybe go ahead and ask your second question and we'll come back to you with that.

Manav Gupta
Analyst, Morgan Stanley & Co. LLC
Q

Sure. What was the RIN compliance cost in the second quarter, and given current RIN prices, what kind of compliance costs are you looking at in the third quarter?

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

A

Okay. I guess you get the award for most technical questions today. Give us a second to pull that data together as well.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

We've got it in front of us.

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

A

Yeah, go ahead if you got turnaround, Mike, I got RINs.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Sure. So we've called out in the initial comments, significant turnaround activity at El Dorado and that includes the cat cracker and the gas-oil hydrotreater as well as some other ancillary units, the alkylation unit comes down along with. So that's probably a 30-day to 35-day outage in aggregate and during that period crude production is brought to about 70,000 barrels per day. So that will be a large turnaround.

In addition to that, we've got a crude unit and two hydro treating units at the Atresia Refinery out in the Navajo system. So the Artesia crude unit distills approximately 35,000 barrels per day of the 100,000 barrels that the Navajo system runs. That gives you an idea of scope of that and again, approximately 30-day down time.

Beyond that, we've got in Woods Cross, some work within our re-former and downstream – upstream naphtha hydro treating, downstream hydrogen consuming units and that's planned for month of October. So that's significant work, but not as large as what is going on at Navajo and El Dorado.

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

A

And on the RIN side, about $35 million spent for the quarter, showing an average price of pretty close to market, around $0.50 per RIN. Assuming no material change there, our estimates going forward are very similar for the third quarter and fourth quarter.

Manav Gupta
Analyst, Morgan Stanley & Co. LLC

Q

Thank you so much, guys. Thank you for your comments.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Sure. Stephanie, are you still with us?

Operator: Yes. I am. We do have another question that has queued up from Jeff Dietert with Simmons. Your line is open.

Jeff A. Dietert
Analyst, Simmons & Co. International

Q

Yeah. It's Jeff Dietert with Simmons.

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Hi, Jeff.

Jeff A. Dietert
Analyst, Simmons & Co. International

Q

I lost the call for part of the call, so I apologize if this has already been discussed. But I was curious if you could discuss the quality of the crude coming in on the Southeast New Mexico system, if you know what that quality looks like? And more broadly, you're continuing to run 80% West Texas sour at Navajo and I was curious about your thoughts on West Texas sour versus WTI Midland crudes. Obviously, both of them are very heavily discounted at this point, but WTS has moved above Midland. Do you think that's sustainable? What are your thoughts there and how flexible are you to your capabilities to adjust at that?

Michael C. Jennings
Chairman, President & Chief Executive Officer, HollyFrontier Corp.

A

Jeff, we've got quite a lot of flexibility because of the infrastructure that we're connected to. The Russell and Hobbs barrels are more sour, more heavy than the light sours that we gather within the HEP gathering system near the refinery, though both sit within the WTS classification.

Beyond that, as we progress south into Southeastern New Mexico and toward White City, our experience today is that we're not seeing the very light sweet barrels. And so we don't have a concern that some have expressed that those are going to be that condensate rich and not effectively fill out the middle of the barrel. That's important, obviously, to diesel economics. So we cover a lot of geography in terms of the crude that we have access to. We don't have concerns about the high gravity material in either our pipeline system or in our refinery.

And with respect to your question about WTS versus TI and grade differentials both as traded in Midland, you know, I think the common lore is simply that when you increase the gravity of the production, that TS barrel is becoming more valuable as blend stock in order to meet pipeline specifications around vapor pressure, if nothing else. So that is where the incremental value that heavier sour barrel, the WTS, appears to be. But we don't have the system constraints that are causing us to value it in the same way as the market appears to be, and we also aren't seeing the real high gravity material.

Jeff A. Dietert
Analyst, Simmons & Co. International

Q

Thank you.

Douglas S. Aron
Chief Financial Officer & Executive Vice President, Holly Energy Partners LP

A

Good. Thanks, Jeff.

Operator: There are no further questions. I'll turn the call back over to Julia for closing remarks.

Julia Heidenreich

Vice President-Investor Relations, HollyFrontier Corp.

Great. Thank you all. Investor Relations will be available this afternoon for any of you have follow-up questions and we'll look forward to our next earnings call in November.

Operator: Thank you. This does conclude today's teleconference. Please disconnect your lines at this time and have a wonderful day.