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HollyFrontier Corp. (HFC)

Q4 2014 Earnings Call

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MANAGEMENT DISCUSSION SECTION

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

Good morning everyone and welcome to HollyFrontier Corporation's full year 2014 earnings call. I'm Julia Heidenreich, Vice President of Investor Relations. This morning, we issued a press release announcing results for the quarter ending December 31, 2014. If you would like to see a copy of the press release, you may find one on our website, www.hollyfrontier.com.

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Before Mike, George 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 federal securities laws. There are many factors that 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 measures. Please see today's press release for reconciliations to GAAP financial measures. Also, please note that the information presented on today's call speaks only as of today, February 25, 2015. 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 it over to Mike Jennings.

Michael C. Jennings

Chairman, President & Chief Executive Officer

Thank you, Julia. Good morning. Thank you all for joining us on HollyFrontier's fourth quarter earnings call. Today, we reported a fourth quarter net loss attributable to HFC shareholders of $222 million or a negative $1.13 per diluted share. Excluding the $397 million non-cash pre-tax inventory valuation charge, the net income attributable to HFC shareholders was $21 million or $0.11 per diluted share. Fourth quarter EBITDA, excluding the inventory valuation charge was $134 million, 15% below the comparable quarter last year.

On a per barrel basis, fourth quarter consolidated refining gross margin was $10.76 versus $10.96 per barrel in Q4 of 2013.

During 2014, we focused a tremendous amount of energy on improving our refinery of reliability. We increased training, emphasizing operating procedure and discipline. Occupational and process safety management teams were formed and we launched a risk-based inspection program across our sites, which we expect to further reduce process safety events. In addition, every refinery employee participated in training aimed at improving hazard recognition and accident prevention.

The benefit of these and other investments being made across our refining system are evident. Our 2014 refinery utilization rate was 91.7%, nearly a 5% improvement relative to 2013 levels and above our five-year average.

2014 lost opportunity was half the 2013 levels, and I'm confident we will continue to see improvements during 2015. With limited 2015 planned maintenance and expected operational improvement, we believe we're well positioned to reap the benefits from improving product margins and widening crude spreads. We have seen a rebound in gasoline demand growth spurred by cheaper gasoline and by an improving labor market in the U.S. Monthly vehicle sales have recovered to pre-recession levels. SUV and light truck sales, in particular, has hit record levels, accounting for over half the vehicles sold in the United States.

I'm encouraged by the relatively strong refining margins in the face of higher utilization rates through the winter months. Mid-Continent 3-2-1 indicator margins have recovered from approximately $2 a barrel in early January to the mid $20 range now in February. While I do not expect dramatic widening in crude differentials, the new inbound pipeline capacity, contango-based storage economics and upcoming refinery maintenance activity should continue to push Cushing inventories higher and spreads wider through much of 2015.

After reaching parity earlier in the year, we've already witnessed the inland coastal crude differential widened to more than $9 a barrel. I anticipate this Brent/WTI spread in the high single to low double digits for much of the

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year. Given our advantage of geographic location close to inland crude product and reduced refinery maintenance activity within the HFC system, we are well positioned to capture the benefit of this spread environment.

Our internal investments target increasing crude access and flexibility, as well as liquid yield improvement. We're on track to complete our El Dorado Naphtha Fractionation project this spring and expect the 14,000 barrels per day Woods Cross expansion project to be completed in the fourth quarter of this year. Both of these investments should generate predictable earning streams and have high tax cost basis, making them attractive candidates for dropdown to our MLP. Our focus is on operational execution, capital allocation now geared incrementally towards share repurchase, completion of our growth projects and capitalizing on the market opportunities presented by a large crude differential.

With that, let me turn it over to George Damiris, our Chief Operating Officer.

George J. Damiris

Chief Operating Officer & Executive Vice President

Thanks, Mike. Fourth quarter crude throughput was approximately 360,000 barrels per day versus our revised guidance of 359,000 barrels per day. We ran $32 sour and 11% WCS and black wax crude. Our average laid-in crude cost across our refining system was $1.50 per barrel under WTI. Total refinery operating costs for the quarter were $270 million. Expenses in the Rockies have increased due to [indiscernible] (07:04) cost in advance of the Woods Cross expansion and our continuing the efforts to improve reliability at the Cheyenne refinery.

In the Mid-Con, we are making improvements to the Tulsa refinery infrastructure demolishing idle tanks and units to make the plant safer and create room for potential future capital projects. In the Rockies, crude throughput was 65,000 barrels per day. We ran 1% sour and 46% WCS and black wax crude. The average laid-in crude cost was $6.70 per barrel under WTI. Refinery operating costs were $10.29 per throughput barrel.

I expect OpEx to revert to historical levels in the $6 to $7 per barrel range when we complete some of the Cheyenne investments and the Woods Cross expansion comes online.

In the Mid-Con region, crude throughput was 200,000 barrels per day. We ran 27% sour and 5% WCS crude. The mechanical repairs to the El Dorado gas oil hydrotreater prompted shift to lighter and sweeter crude slate, requiring us forfeit attractive to light heavy differential in the quarter. As a result, average laid-in crude cost was $0:68 per barrel over WTI. Refinery operating costs were $7.05 per throughput barrel.

Tulsa lube sales in the fourth quarter were approximately 85,000 barrels a day with an average frac approximately $75 per barrel. We have since completed repairs to the El Dorado gas oil hydrotreater and are once again running heavy crude at the refinery. In Southwest region, crude throughput was 95,000 barrels per day. We ran 100% Permian crude, of which 63% was sour. Our average laid-in crude cost was $3.56 per barrel under WTI. Refinery operating costs were $5.54 per throughput barrel. We successfully completed the planned turnaround of the 35,000 barrel a day Artesia crude unit during the first quarter.

Total lost opportunity in the quarter was $36 million, much of which was related to the El Dorado gas oil hydrotreater. As Mike mentioned, in 2014, we began to see the benefit of our efforts to improve reliability across our refining system, cutting our lost opportunity in half relative to 2013 levels.

For the first quarter 2015, we expect to run 400,000 barrels per day of crude with 27% of the slate being sour and another 20% being WCS and black wax crude. In addition to the Navajo crude unit turnaround which was

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completed in early February, our 2015 turnaround schedule includes a second quarter crude unit turnaround at the Woods Cross refinery.

With that, I'll turn it over to Doug for some closing remarks.

Douglas S. Aron

Chief Financial Officer & Executive Vice President

Thanks, George. For the fourth quarter of 2014, cash flow provided by operations totaled negative $47 million. I'd like to mention a few items that impacted the quarter. We incurred a $27 million pre-tax environmental accrual and a $20 million write-off of assets that were no longer usable. Fourth quarter capital expenditures totaled $178 million, which excludes HEP's $18 million capital spend. This takes our full year capital expenditure to $485 million excluding HEP's $80 million capital.

Turnaround spending in the quarter totaled $65 million, taking our full year 2014 spend to $97 million. In 2015, we expect to spend $600 million to $650 million in capital and additionally $70 million on tanks and turnarounds.

As of December 31, 2014, our total cash and marketable securities balance stood at $1 billion, a $437 million reduction from the September 30 levels. Cash outflows in the quarter included $187 million in dividends and share repurchases and $178 million in capital expenditures.

Through 2014, we returned a significant portion of our cash earnings to shareholders with dividends totaling $3.26 per share. Last week, we announced our $0.32 per share regular quarterly dividend, which puts our yield at 3.1% as of last night's close towards the top end of the peer group range.

Given the pullback in share in share price, we decided last week to reallocate the special dividend spending towards share repurchases. During the fourth quarter, we repurchased 540,000 shares at an average price of $43 per share. Year-to-date, we have repurchased an additional 433,000 shares. Last week, our board authorized a new $500 million share repurchase program replacing all existing share repurchase authorizations. Going forward, we expect to be more aggressive in our share repurchase program.

HollyFrontier debt totaled $187 million, including non-recourse HEP debt of $868 million. HollyFrontier owns 39% of Holly Energy Partners, 22.4 million common units plus the 2% general partner interest. The current market value of our LP units is approximately $770 million as of last night's close. Fourth quarter general partner incentive distributions were $9.8 million, a 22% increase over the same quarter last year. For the full year 2014, we received approximately $83 million in cash distributions from HEP.

Lastly, a reminder that you can find monthly WTI-based 3-2-1 indicators for our Mid-Con, Rockies and Southwest regions posted on HollyFrontier's Investor page. These regional indicators do not reflect actual sales and are meant to show monthly trends. Realized gross margin per barrel may differ from the indicators for a variety of reasons. You may find the data on our Investor page at hollyfrontier.com.

And now, Audrey, we're ready to take questions.

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QUESTION AND ANSWER SECTION

Operator: The floor is now open for questions. [Operator Instructions] Thank you. Our first question comes from the line of Paul Cheng with Barclays. Your line is open.

Paul Y. Cheng
Barclays Capital, Inc.

Q

Good morning, guys.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Hi, Paul.

Paul Y. Cheng
Barclays Capital, Inc.

Q

Two question. Doug, I just want to make sure I got you correctly. You say 2015 CapEx is $600 million to $650 million plus another $70 million in the turnaround. That number seems to be a bit higher than what we expect. Can you break down between on the refining and the logistic?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

So, Paul, that's mainly all going to be the refining side. The reason that number is higher than what you've seen in years past is we've got the completion of the Woods Cross expansion this year. That project is still expected in the previous guidance range of $375 million to $400 million, but we've got roughly half of that spending still to do in calendar 2015. In addition, the completion of the El Dorado naphtha fractionation project that occurs this year, that's spending largely again in 2015. And then the maintenance levels within our plants are roughly the same. I can't think of really any other big items, but the completion of those two projects are going to be the ones that stand out taking those numbers higher.

Paul Y. Cheng
Barclays Capital, Inc.

Q

How much is the second project that you mentioned?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

The total is $100 million, left to spend is...

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

$70 million.

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

...$70 million, so 70%.

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Paul Y. Cheng
Barclays Capital, Inc.

Q

70%, so there's...

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

So of our $600 million to $650 million, Paul, that's nearly $270 million left to spend this year.

Paul Y. Cheng
Barclays Capital, Inc.

Q

Okay. That's seems though you're still a little bit high. I thought your sustaining capital in the refining is more like in the $300 million or so only.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

That's accurate, Paul. So the difference is really those two significant growth projects, basically projects that have been previously appropriated and are being completed now. We have a Tier 3 gasoline project, which is obviously environmental compliance-related at the El Dorado refinery. That's going to cost approximately $65 million. We've got a hydrogen plant going in at Cheyenne in this current year in the $45 million to $50 million range. So these are projects that were appropriated a couple of years ago and are coming now into their construction phase and being completed.

The sustaining capital for the plants including turnarounds is really very much in the range of $200 million to $250 million. So these growth projects that are now in the construction phase and near to complete that are going to consume the large part of the cash spending this year.

Paul Y. Cheng
Barclays Capital, Inc.

Q

Okay. And what is the HEP CapEx spending for this year?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

$70 million to $75 million, Paul, so I'm fairly certain we said yesterday on the HEP call.

Paul Y. Cheng
Barclays Capital, Inc.

Q

Right. So that means that in your cash flow statement when we're looking at that, the CapEx line should be somewhere in the $670 million to maybe $725 million, something like that, right, because that's fully consolidating your result.

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

That is correct. Some of those still we're consolidating the results.

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Paul Y. Cheng
Barclays Capital, Inc.

Q

And Mike, can you elaborate a little bit in terms of what is your growth strategy and target for the HEP? And do you have a target in terms of some of your competitor talking about third-party revenue? They want to increase it to a certain percentage. Some people will go for a 50/50; some just even go more aggressively 70/30. Do you have some kind of objective here? And also that whether you want to expand the HEP beyond the existing product line into also looking at natural gas and gathering and all that, or that you're going to stick with the core point of refined product and crude logistic?

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

That's a rich question, Paul. Let me try to address at least the bulk of it. The growth strategy for HEP is two-fold. First is around continuing to partner with HFC in projects that have stable and high cash returns. The El Dorado Naphtha Fractionation project is a very good example of that. It's effectively a gas-to-liquids project as we've described in the past using more natural gas to generate hydrogen, less reformer feed to do the same thing.

The project returns are somewhere between two and three years of pre-tax cash payback on the original investment amount depending crude oil price environment that we're talking about. But this kind of project to my mind fits very well into HEP, and we'll continue to seek those kind of projects out.

Also very important is external growth and the third-party revenue that everyone in this industry covets. Our best likelihood of doing that is through expanding the Permian gathering system. We've got a strong footprint in a franchise out there. Malaga was our most recent investment and we're doing a very good job of filling that, ultimately moving those barrels to the Cushing market into our own refineries. So strategically, we like the Permian in terms of third-party revenue growth and we very much like to continue to partner with HFC in these high margin predictable dropdowns, the likes of which we called out in terms of the El Dorado Naphtha Frac projects and a portion of this Woods Cross Phase 1 project.

Paul Y. Cheng
Barclays Capital, Inc.

Q

Thank you.

Operator: Your next question comes from the line of Doug Leggate with Bank of America. Your line is open.

Doug Leggate
Bank of America Merrill Lynch

Q

Thanks. Good morning, everybody. Thanks for getting me on the call. Mike, you gave a fairly good explanation now end of the year, but what was going on regarding the extended maintenance? I wonder if you could help quantify an opportunity cost that goes along with that, particularly related to the change in crude slate. And I guess what I'm really trying to understand is most of your competitors reported much stronger capture rates reflected in the kind of lag effect on the bottom of the barrel where you guys did appear to benefit from that. So I'm wondering if you can just help us understand what was going on there. And I've got a quick follow-up, please.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

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Yeah. I'm going to let George speak to that. But you're right; we got our timing exactly wrong relative to attractive heavy crude differentials in the fall. But we had a planned turnaround and we obviously needed to take it.

George, in terms of quantifying.

George J. Damiris
Chief Operating Officer & Executive Vice President
A

Yeah. I think, as we said, the lost opportunity for the quarter was $36 million, Doug, and I'd say the vast majority of that was associated with the El Dorado gas oil hydrotreater and our inability to run WCS and we had replaced it with WTI.

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

But beyond that, just the nature of having the planned turnaround cost another approximately $50 million. We wouldn't consider that lost opportunity, because it was a planned event and obviously something we needed to do. But relative to competitors and capture rates, that might help to reconcile.

Doug Leggate
Bank of America Merrill Lynch
Q

All right. That's should be helpful. We'll look – say run to that a little bit. I guess, Mike, my follow-up is more to a macro question because obviously the – I mean clearly, the whole sector has benefited from the tailwind, has been the very strong rebound in margins, I guess the economic run cuts at the beginning of the year were part of that. But similar thing going on I guess with the WTI/Brent spread. And I'm just kind of curious what gives you confidence in your kind of double digit assumption for this year given that we have got a very steep contango currently and obviously, there's a lot of refiners offline currently that are expected to come back. I'm just kind of - we're all grappling with this $50, $60 oil prices that tend to go overspread seems a little egregious to sustainable levels. I'm just curious what's behind your thoughts and I'll leave it there. Thanks.

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

Doug, I think that that's the level that we'll achieve. Whether that's an average level for the year, I really have no idea. But the fact is that despite rigs being laid down and those numbers that we all look carefully at week-on-week, production continues to grow in the U.S. and lot of that production is finding its way into tankage at Cushing. It's incented to do so obviously by the contango storage and we're moving now into more maintenance season, particularly in the Mid-Con. So I believe that Cushing is going to fill or close to fill to operating levels and if that will carry over through a decent portion of the year in terms of impacting inland versus coastal crude differentials.

Doug Leggate
Bank of America Merrill Lynch
Q

All right. I appreciate the answers, Mike, and look forward to seeing you guys next week. Thanks.

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

Thank you.

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

Roger D. Read
Wells Fargo Securities LLC
Q

Hey, good morning.

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

Hi, Roger.

Roger D. Read
Wells Fargo Securities LLC
Q

I guess I'd like to follow up a little bit on the utilization and your comments earlier about kind of taking a more risk-based focus, everything like that. So utilization of 5% in 2014 versus 2013, a steady level of maintenance expected this year. How do you look at refining utilization potential this year? So 91.7% in 2014. Can we see that creep up 100 basis points, 200 basis points? And then kind of follow-on to Doug's question about the differentials. Would that affected if you were looking at an average differential of, say, $3 as opposed to today's $9? How would you think that might affect the utilization potential?

George J. Damiris
Chief Operating Officer & Executive Vice President
A

Yeah. This is George Damiris, Roger. I think on the utilization side, we – 2015, we are going to have a lighter turnaround schedule than we had the last couple of years. The two notable turnarounds were the crude unit on Artesia, which is already behind us. And then we'll then have a turnaround at Woods Cross sometime this summer at that crude unit. So that's basically – yes, those are our two major turnarounds and one of them is already behind us, so I would expect that we can add to the utilization rate accordingly.

Roger D. Read
Wells Fargo Securities LLC
Q

But you commented earlier about spending. It sounded like the CapEx directed towards maintenance was about the same, so it's just a deeper turnaround at those units but less capacity offline as a result of that.

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

Roger, the comment on maintenance was maintenance capital as opposed to turnaround spending. The turnaround spending this year is really fairly low. I think from memory it's in the $40 million range, which doesn't afford much turnaround.

Roger D. Read
Wells Fargo Securities LLC
Q

Okay.

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

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The turnaround, as we called out, crude unit in Artesia, which is the small crude unit in Navajo system and then the crude unit up Woods Cross. So the lower turnaround activity coupled with anticipated higher reliability certainly achieves a couple hundred basis points, if not higher.

Roger D. Read
Wells Fargo Securities LLC
Q

Okay. That's helpful. And then to the share repurchase program now more of a focus, the special dividend looking like more of a rearview mirror event. As you look, and commented earlier about being more aggressive in the share repurchase area, what is the sort of economic model for your decision on when to buy back your shares versus not. I mean, just year-to-date or you go back to mid December, the stocks obviously had a real nice move here. And I'm just wondering easy to be aggressive on lower price, how do you evaluate it as the price goes up? And just anything you could do to help us to understand that.

Douglas S. Aron
Chief Financial Officer & Executive Vice President
A

Sure. But let's first talk about I think the question – the big move-up. I saw some commentary when they made the announcement last week about not having repurchases made shares as perhaps folks would have expected in the fourth quarter. And what I would tell you is that we had our sights set on what I think was a transformative transaction for our company, one that we thought was a significant opportunity for us and had us in cash-saving mode.

That opportunity ended up not coming to fruition and I won't be specific, but I'm sure most can guess as to what I'm talking about. And so it would've taken a different direction in our last board meeting. I would tell you that in the near term and having suspended the special dividend, we'd expect to repurchase something in the neighborhood of nearly $100 million worth of stock over the next 90 days that would otherwise match what our special dividend payment would have totaled for the quarter. And also caution though that while our current posture is to favor share repurchase, it doesn't mean that the special dividend is necessarily gone forever. We really just remain committed to maximizing shareholder value and returning capital to shareholders through dividends and share repurchases and would again point to our track record of having returned nearly $3 billion since our merger in 2011 through the combinations of dividends and share repurchases.

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

Beyond that, Roger, I think probably we're going to be a little more agnostic as to price and simply allocate capital to share repurchase as compared to our past where we really allocated the bulk of our distributions to cash dividend and try to be very opportunistic with respect to share repurchase. As we ramp share repurchase up proportionally, we're going to need to be in the market more consistently.

Roger D. Read
Wells Fargo Securities LLC
Q

Okay, that's helpful. Thank you.

Operator: Your next question comes from the line of Ryan Todd with Deutsche Bank. Your line is open.

Ryan Todd
Deutsche Bank Securities, Inc.
Q

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Great. Thanks, gentlemen. Maybe if I could ask a question on your thoughts on WCS. It would appear that we have material inventories building in Cushing with this kind of cycling needing to widen to eventually clear those inventories. Can you talk a little bit about what you're seeing in WCS, your outlook? And with widening Brent/WTI just as well, how are the relative economics looking between running light and heavy crude right now?

George J. Damiris
Chief Operating Officer & Executive Vice President
A

Well, as you know, WCS depth has come in from roughly $20 per barrel to more of the low teens, $13 currently. I think at that level, it's still attractive to run some WCS at our refineries, especially Cheyenne which has a lower transportation cost to get the WCS. But also El Dorado, which, as you know, is attached to Cushing and we have the alternative there to either run the WCS at El Dorado or sell it into the open market.

I think WCS is still very attractive for Gulf Coast refiners relative to Maya. Maya is trading about $3 under WTI, whereas WCS is trading at about $7 under WTI in Cushing. And with the Cushing, the Gulf Coast pipeline capacity available, there's a lot of WCS going from the Cushing market to the Gulf Coast to compete with Maya.

Ryan Todd
Deutsche Bank Securities, Inc.
Q

Okay. And from a – any insight that you guys have in terms of maybe relative level of WCS or light heavy versus light inventories in Cushing?

George J. Damiris
Chief Operating Officer & Executive Vice President
A

I think there's a lot of WCS being stored as part of the contango play in Cushing. I don't have any specific volume, percentage of volume that's going in inventory that's WCS versus WTI. I think it's fair to say that there's a good percentage of the contango play that's being stored at WCS.

Ryan Todd
Deutsche Bank Securities, Inc.
Q

Okay. And maybe if we could shift gears a little bit to – and I appreciate that maybe there's not much change on this from the last call, but any update on your current thoughts for the potential for the Woods Cross Phase 2 expansion? Is that likely to remain on hold until we see more clarity on the supply outlook and how the crude compression plays out? Or I guess any thoughts on timing and outlook for the expansion there?

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

I think on hold is a good way to describe it. We've done some very good upfront engineering, estimating and permitting work and we certainly hope that that comes to fruition. But it is a crude-specific project and with $50 WTI, you don't see lot of drilling activity in the Uinta. So we're going to need to see a change in crude price in order to get the producers back in the game and wanting to look forward to these long-term supply contracts that would cause us to push forward with that project.

Ryan Todd
Deutsche Bank Securities, Inc.
Q

Great. Thanks a lot. I'll leave it there.

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Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Thanks, Ryan.

Operator: Your next question comes from the line of Jeff Dietert with Simmons, your line is open.

Jeffery Alan Dietert
Simmons & Company International

Q

Good morning.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Hi Jeff.

Jeffery Alan Dietert
Simmons & Company International

Q

I was – just want to clarify on Woods Cross Phase 1, you've got contractual commitments there for supply, and are those take-or-pay contracts with the reduction in drilling activity. Just want to confirm you're not at risk there.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Well, the nature of the contract is not that the producer has to produce, but there is a consequence if the producer doesn't produce.

George J. Damiris
Chief Operating Officer & Executive Vice President

A

That's right. To extent that production doesn't meet the contract volume, there is a mechanism in place. So we receive compensation for any volume shortfall. Neither us nor our suppliers clearly want this mechanism to be triggered. Obviously, producers want to produce and refiners want to refine oil. But to the extent that there is a shortfall, that shortfall at least triggers that compensation which provides us with a positive return on our investments and that's for any margin we generate by utilizing that capacity with an alternative crude supply.

Jeffery Alan Dietert
Simmons & Company International

Q

Yeah. I would assume it's a base load – viewed as a base load contract for the suppliers as well. Secondly, could you talk about with the West Coast refinery outages and higher margins on the West Coast; I assume that's impacting Las Vegas. Is that creating opportunities both for HFC and HEP on the Unev pipeline?

George J. Damiris
Chief Operating Officer & Executive Vice President

A

Yes. We're taking as much volume as we can within our contractual commitments to other customers in the Salt Lake and other markets. We're taking as much of volume as we can to Vegas and the same applies for Navajo, where we're taking as much products as we can to the Phoenix market to take advantage of the West Coast basically being short product right now.

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Michael C. Jennings
Chairman, President & Chief Executive Officer

A

As you identified, Jeff, these product shipments on unit line are higher as well and there's pretty strong driver to move product from the Rockies down to the Las Vegas market and it's just really a question of available barrels to do so.

Jeffery Alan Dietert
Simmons & Company International

Q

Thanks for your comments.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Thank you.

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

Paul Y. Cheng
Barclays Capital, Inc.

Q

Hey guys. Quick question. Do you have any leased space either by you or by HEP in the Cushing area that you can pay the contango?

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Yes, we do. Much of the things we have is operational in nature, but we do have space that we play the contango with as well.

Paul Y. Cheng
Barclays Capital, Inc.

Q

And have you guys did increase or changed your inventory as a result of contango then?

George J. Damiris
Chief Operating Officer & Executive Vice President

A

I would say have not increased our inventory levels significantly.

Paul Y. Cheng
Barclays Capital, Inc.

Q

Is there any reason not then?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

Paul, we're turning as much as we can within the constraints of our storage both at Cushing and at our refineries.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

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It's something that we're really reviewing at the refinery level in addition, Paul, because not just Cushing; we have tanks, as you might imagine, throughout the system and the question is how much inventory do we want carry and with what contango economics, but obviously there's a strong driver there.

Paul Y. Cheng
Barclays Capital, Inc.
Q

I have to apologize because I came into call a little bit late. You may have already mentioned that at the beginning of the call, what's the nature of the write-down?

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

On the asset write-downs, Paul?

Paul Y. Cheng
Barclays Capital, Inc.
Q

That's correct.

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

The largest of that – I mean there were several that were small that sort of added up to a big number. The one that accounted for $15 million pre-tax and about $0.05 per share after-tax was a pipe in Sidney, Nebraska that we had. We thought potentially a higher crude price environment might have an ability to move some Niobrara crude or otherwise in the current environment just seemed as though that was not going to come to fruition in the near term and as a result, made a decision to go ahead and take that off our books.

Paul Y. Cheng
Barclays Capital, Inc.
Q

Something in your...

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

Paul, I'm sorry to do this to you, if we could maybe get you back in the queue...

Paul Y. Cheng
Barclays Capital, Inc.
Q

Okay. Thank you.

Operator: Your next question comes from the line of Manav Gupta with Morgan Stanley. Your line is open.

Manav Gupta
Morgan Stanley & Co. LLC
Q

Guys, thank you for taking my question. You mentioned you expect Cushing to fill up to an operatable capacity is a very interesting comment. I'm just trying to understand what's the timeframe you think this could happen.

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

You want us to give both a number and a date. That's tough, Manav. The storage appears to be filling at between 4 million and 6 million barrels a week.

Manav Gupta
Morgan Stanley & Co. LLC
Q

Right.

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

I believe there's probably 30 million barrels of capacity remained to be filled, 25 million to 30 million range. Probably 30 million is a good number. So if you said over the next 8 to 10 weeks, I think that would probably be a pretty conservative number and that also corresponds to a season in which there will be some significant maintenance in the Cushing market and in the Mid-Con more generally, so that would be my forecast.

Manav Gupta
Morgan Stanley & Co. LLC
Q

That's very helpful. I'm extremely sorry if I missed this, but can give your throughput guidance for 1Q one time again? I'm sorry if I missed it.

George J. Damiris
Chief Operating Officer & Executive Vice President
A

Yeah. We gave guidance of 400,000 barrels a day.

Manav Gupta
Morgan Stanley & Co. LLC
Q

Okay. And can you split by regions, sir?

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

No, we don't tend to do that.

Manav Gupta
Morgan Stanley & Co. LLC
Q

Okay.

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

I mean, what I would tell you is that number does include the Navajo turnaround that George already mentioned, so you'd expect the Southwest region to be on the lower end. But otherwise, we only give consolidated guidance.

Manav Gupta
Morgan Stanley & Co. LLC
Q

That's perfect. Thank you for taking my questions. Thank you.

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Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Thanks, Manav.

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

Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

Thanks very much for the questions. The MLP, you mentioned obviously that you got a high tax based on some of the assets that you're building in the refining space, and obviously, those are going to be profitable assets that make sense. Is there a sense of how much EBITDA you'd be willing to discuss today that would form the basis of those drops?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

We really haven't scoped that quite yet, but if we think in the neighborhood of more than 10% and less than 50% for those assets that we called out, that's probably a good range. But there will be more to come certainly by the second quarter call.

Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

Right. And is this a shift to see some of your competitors in the space sort of drawing lines around different parts of the refineries and dropping them down into the MLPs and creating fee income and then just taking the hit on OpEx at refining level? Is there's a general thought still present to do more of that?

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Well, look, what I would say is we're not ignorant of the 5x versus 15x multiple differential between these securities. How we play it? I think what we've said is really what we're looking for the high basis steady return portions of the refinery. Each business is different. Some folks look to retail versus wholesale and such like that. It depends a lot on one zone business strategy. Ours really has been to emphasize the newer projects which have more stable returns and that's where we're going to be taking it for the next little while.

Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

Okay. And then a separate question. I mean, obviously, a lot of focus on crude, but product inventories up in have been Group III and in the Mid-Con are relatively high. So I guess I'm just wondering how do you think that might affect your capture of this very good environment that we should expect over next few months.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Inventories in the Magellan system and in Pad 2 have been pretty well behaved given the time of year. We had a very high run rates in December and even January and still inventory – there is inventory capacity. The system is functioning well and the margins are good. I suggest the question is will the refiners store this cheap crude as products and I see demand is offsetting that. Right now, you've some winter weather that's depressing that, but

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gasoline demand is very good in the markets that we serve, and then we expect that it will get better as pull out of winter towards a more normal driving season.

Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

Thanks very much.

George J. Damiris
Chief Operating Officer & Executive Vice President

A

Just to add, I think there's also significant turnaround in the Mid-Continent that result in inventory levels falling faster than they may have in prior years.

Edward George Westlake
Credit Suisse Securities (USA) LLC (Broker)

Q

Yeah. It's just the competitors close to guys. I was just worried about it, so I just wanted to check your thoughts.

George J. Damiris
Chief Operating Officer & Executive Vice President

A

Okay.

Operator: Your next question comes from the line of Chi Chow with Tudor, Pickering, Holt. Your line is open.

Chi Chow
Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Great. Thank you. Just, Mike, a point of clarification on the after-drop fractionator and the Woods Cross expansion, are you talking about a tolling arrangement that you're looking to create with HFC?

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Well, who you construe whether it's T&D or tolling, effectively it's deeper service relative to the MLP potentially funding a significant portion, if not all, of the asset. And so I wouldn't be proposing to put much, if any, margin risk into the MLP. We have a fixed distribution MLP, which traditionally has provided a terminalling pipeline tankage services to the refining company and I think to the extent that we see processing units in there would be under the same services concept.

Chi Chow
Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Okay, great.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Does that answer your question, Chi?

Chi Chow
Tudor, Pickering, Holt & Co. Securities, Inc.

Q

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Yeah, I think so, I guess.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

I think that's synonymous with tolling. I haven't really construed it that way, but I think it's the same thing.

Chi Chow
Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Okay. Okay, great. And Doug, can you give us the hedging impact in the quarter both on the guess on the crude side and WCS side and then the product?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

Yeah, I can. Let me – yes, I will. The answer is on the product side, we had, for the quarter, about a $20 million accounting gain and on the economic side, which is basically the crude drop; we had a $65 million economic gain. $55 million of that was realized in the quarter, the other is sort of a mark-to-market, Chi.

So in total, about $85.3 million of derivative gain for the quarter. That was, in total, completely offset by LIFO revaluations, if you will, of almost the exact same number, which is why we chose not to call them out. The net was about a zero, but as you can imagine with the big price moves, there was a large LIFO loss also in the period, which was again almost right at that $85 million number.

Chi Chow
Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Okay, great. And can you provide any guidance for 2015 on your hedge positions for the product in crude?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

Crude, our position is to continue to just only hedge inventory in excess of what we call our base levels. So when we build inventories for turnarounds or otherwise, and there aren't many turnarounds, so we don't have a whole lot of excess inventory planned this year, we tend to hedge that. So certainly, I wouldn't plan for anything there.

In terms of our product hedges, I think the number is 12,000 barrels a day of diesel hedged in the Mid-Continent for little north of $30 a barrel.

Chi Chow
Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Okay, great. Thanks. And maybe just one more, any impact on your end or how are you preparing of any strike activities that may come your way from USW?

George J. Damiris
Chief Operating Officer & Executive Vice President

A

Yeah. We're in strike preparation right now, Chi. We think we're going to be ready if and when it comes. We don't think it's going to come to our plants, but one never knows where this is going to go.

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Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Mention the plants that are affected.

George J. Damiris
Chief Operating Officer & Executive Vice President

A

Yeah. And as you probably know, the plants where we have USW representation is El Dorado, Cheyenne, those are the two – and then Woods Cross as well.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Yeah.

Chi Chow
Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Okay. Great thanks, George. Appreciate it.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

What I'd add for unsolicited color is that our local relationships are between very good and excellent and I think you can read in the press a good characterization of the driver in terms of this current strike. It has maybe less to do with wages and safety and things like that and more to do with bringing non-union contractors onto the union payrolls. And it's going to be a difficult conversation at the national level, but locally, we have great workforce and good relations with them.

Chi Chow
Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Okay. Thanks, Mike. Appreciate it.

Operator: Your next question comes from the line of Brad Heffern with RBC Capital Markets. Your line is open.

Brad Heffern
RBC Capital Markets LLC

Q

Good morning, everyone. Maybe a question for Doug. You've talked in the past about how you're comfortable at a much higher leverage level on the balance sheet than you're currently at. I was wondering what are the items that you would potentially use the balance sheet for? Is that strictly acquisitions or is there a chance that you would use that to repurchase shares?

Douglas S. Aron
Chief Financial Officer & Executive Vice President

A

Well, I think the answer is certainly we would use the balance sheet if we had what we saw as a high return accretive acquisition opportunity. In terms of the share repurchase or using debt to pay dividends, I think we'd probably need to at least deplete our existing cash balance of $1 billion before we entertain that conversation.

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What I would tell you and what I've said in the past is certainly our current capital structure is not optimal, especially given the low rates that are available for investment grade companies to borrow money. So over the course of the next 24 months and maybe sooner than that, as we have enumerated a pretty large capital expenditure program for 2015, I think taking some debt onto the balance sheet over the next year or two may very much make some sense absent the acquisition opportunity, but we're not there yet.

Brad Heffern
RBC Capital Markets LLC
Q

Okay. And can you remind us what sort of minimum cash balance you're comfortable with?

Douglas S. Aron
Chief Financial Officer & Executive Vice President
A

I would tell you that depends I guess a bit in the price of WTI. You certainly want be able afford to buy crude oil. We do have $1 billion revolver, which is really largely completely unused. I mean, we've got a couple of LCs to government agencies that I can think of. But other than, it's is largely unused. So we had pegged $1 billion historically and saying that would be where we would reconsider the special dividend or share repurchases.

I think especially in a $50 WTI environment, we're certainly comfortable inside of that. Whether that new number is $500 million or something even less than that, I'm not sure I'd want to commit to that. But we certainly wanted – it's better said to make sure that we have sufficient liquidity to run our business, and that includes the ability to fund our capital programs and to buy crude oil for our plants and that number moves around a bit, but it's lower than what our cash balance is today.

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

Bottom line is we feel like we have a lot of running room in terms of share repurchase and other distributions to shareholders, but before we hit any kind of liquidity or capital structure constraint.

Brad Heffern
RBC Capital Markets LLC
Q

Okay, that's great color. Thanks. And then speaking about El Dorado and the hydrotreater issues, was there any of that that spilled over into the first quarter that maybe affected the crude play?

George J. Damiris
Chief Operating Officer & Executive Vice President
A

I think it might have for a couple of days, but nothing significant.

Brad Heffern
RBC Capital Markets LLC
Q

Okay, great. Thank you.

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

Those repairs were completed in early January.

Operator: Your next question comes from the line of Jeff Dietert with Simmons. Your line is open.

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Jeffery Alan Dietert
Simmons & Company International

Q

My questions have been answered. Thank you.

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

Mohit Bhardwaj
Citigroup Global Markets, Inc. (Broker)

Q

Now, thank you for taking my question. Just wanted to follow up on the dropdown potential from the two projects that you're considering. So if you look at the guidance that you've given for both Woods Cross and also for El Dorado, how much of that total EBITDA that you expect could be dropping? I know you mentioned $10 million to $50 million, but is it possible that the entire, say, $150 million could be dropped [ph] in light of anything (51:59) was made?

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

I think doing that would require either of the two entities to take a lot of what I'll call tail risk or residual risk, where we're probably more comfortable dropping a portion of the EBITDA and retaining a significant portion in the refining company. And the reason for that is it to be able to drop a steady stream of cash flow into the MLP as opposed to a variable stream, sort of giving us margin for error or margin for price and margin volatility in the future.

They're really – there isn't an upward limit on this other than what's reasonably appropriate. We also have, as you might imagine, the capital cost or the tax basis in the asset. When you exceed that, you start to pay tax, which is considerably less efficient when you give away 40% of the price to the government in the process.

Mohit Bhardwaj
Citigroup Global Markets, Inc. (Broker)

Q

Right. Thanks for that. And just on Tulsa, is there any update on the permit filing to utilize the entire 170,000 barrels per day over there?

George J. Damiris
Chief Operating Officer & Executive Vice President

A

That's in regard to Tulsa, I'm sorry.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Yeah, the Tulsa permit filed.

George J. Damiris
Chief Operating Officer & Executive Vice President

A

Yeah. I think everything is proceeding as we anticipated on that permit and we expect to get it sometime soon.

Mohit Bhardwaj
Citigroup Global Markets, Inc. (Broker)

Q

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Great. Thanks for taking my questions.

Michael C. Jennings
Chairman, President & Chief Executive Officer

A

Thank you.

Michael C. Jennings
Chairman, President & Chief Executive Officer

Okay. Looks like the question queue has been depleted. Thank you all for joining us on our call and we look forward to talking to you either next quarter or the interim. Thank you.

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

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