

VIRTRA SYSTEMS INC
Form SB-2
April 06, 2005

AS FILED WITH THE SECURITIES AND EXCHANGE COMMISSION ON APRIL 6, 2005.

REGISTRATION NO. _____

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549
FORM SB-2

REGISTRATION STATEMENT

UNDER

THE SECURITIES ACT OF 1933

VIRTRA SYSTEMS, INC.

(NAME OF SMALL BUSINESS ISSUER IN ITS CHARTER)

TEXAS

(State or other jurisdiction of
incorporation or organization)

334310

(Primary standard industrial
classification code number)

93-1207631

(IRS employer identification
number)

440 North Center

Arlington, Texas 76011

(817) 261-4269

(ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING

AREA CODE, OF REGISTRANT'S PRINCIPAL EXECUTIVE OFFICES)

440 North Center

Arlington, Texas 76011

(817) 261-4269

(ADDRESS OF PRINCIPAL PLACE OF BUSINESS OR INTENDED PRINCIPAL PLACE OF BUSINESS)

L. Kelly Jones, chief executive officer

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440 North Center

Arlington, Texas 76011

(817) 261-4269

(NAME, ADDRESS, INCLUDING ZIP CODE, AND TELEPHONE NUMBER, INCLUDING
AREA CODE, OF AGENT FOR SERVICE)

COPIES TO:

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COUNSEL TO ISSUER

APPROXIMATE DATE OF COMMENCEMENT OF PROPOSED SALE TO PUBLIC: AS SOON AS
PRACTICABLE AFTER THE REGISTRATION STATEMENT BECOMES EFFECTIVE.

IF DELIVERY OF THE PROSPECTUS IS EXPECTED TO BE MADE PURSUANT TO RULE 434, CHECK THE
FOLLOWING BOX.

CALCULATION OF REGISTRATION FEE

TITLE OF EACH CLASS OF SECURITIES TO BE REGISTERED	AMOUNT TO BE REGISTERED	PROPOSED MAXIMUM OFFERING PRICE PER SECURITY (1)	PROPOSED MAXIMUM AGGREGATE OFFERING PRICE	AMOUNT OF REGISTRATION FEE
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Common Stock, \$.005 Par Value (2)	18,000,000	\$.31	\$5,580,000
Common Stock, \$.005 Par Value (3)	6,800,000	\$.31	2,108,000
Common Stock, \$.005 Par Value (4)	750,000	\$.33	247,500
Common Stock, \$.005 Par Value (5)	75,000	\$.31	23,250
Total	25,625,000		\$7,958,750

(1) All shares are to be offered by selling shareholders from time to time at fluctuating market prices. The registration fee for these shares is calculated in accordance with Rule 457(c). Except as otherwise noted, the maximum offering price is based upon \$0.3075 per share, which was the average of the bid and ask prices for our common stock as reported on the OTC Bulletin Board on March, 21, 2005, rounded to two decimal places.

(2) Consists of up to 18,000,000 shares which may be issued to Dutchess Private Equities Fund II, L.P. under the investment agreement relating to our equity line.

(3) Consists of up to 6,800,000 shares which may be issued to holders of our convertible subordinated debentures issued on February 25, 2005.

(4) Issuable upon the exercise of common stock purchase warrants issued to Dutchess Private Equities Fund, L.P., and Dutchess Private Equities Fund II, L.P. the debenture holders on February, 25, 2005. The exercise price of the warrants is \$0.33, but is subject to adjustment under some circumstances.

(5) Consists of 75,000 shares to be sold by a shareholder who acquired the shares in an earlier private placement transaction.

In accordance with Rule 416 promulgated under the Securities Act of 1933, this registration statement also covers such indeterminate number of additional shares of common stock as may become issuable upon stock splits, stock dividends, or similar transactions.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(a) OF THE SECURITIES ACT, OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(a), MAY DETERMINE.

PROSPECTUS

VirTra Systems, Inc.

440 North Center, Arlington, Texas 76011 (817) 261-4269

The Resale of 25,625,000 Shares of Common Stock

The selling price of the shares will be determined by market factors at the time of their resale.

This prospectus relates to the resale by the selling shareholders of up to 25,625,000 shares of common stock. The selling shareholders may sell the stock from time to time in the over-the-counter market at the prevailing market price or in negotiated transactions. Of the shares offered,

- 75,000 shares are presently outstanding,
- up to 18,000,000 shares are issuable to Dutchess Private Equities Fund II, L.P., based an investment agreement dated as of February 25, 2005.,
- up to 6,800,000 shares are issuable to Dutchess Private Equities Fund, L.P., and Dutchess Private Equities Fund II, L.P., as holders of our convertible subordinated debentures issued on February 25, 2005, and
- up to 750, 000 shares are issuable upon the exercise of warrants issued to the debenture investors,

We will receive no proceeds from the sale of the shares by the selling shareholders. However, we may receive up to \$6 million of proceeds from the sale of shares to Dutchess Private Equities Fund II, L.P., and we may receive additional proceeds from the sale to the Dutchess funds of shares issuable upon the exercise of any warrants that they may exercise.

Our common stock is quoted on the OTC Electronic Bulletin Board under the symbol VTSL. On March 21, 2005, the average of the bid and asked prices of the common stock on the OTC Bulletin Board was \$0.31 per share.

Investing in the common stock involves a high degree of risk. You should not invest in the common stock unless you can afford to lose your entire investment. **See "Risk Factors" on page 7.**

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

The date of this prospectus is April 6, 2005.

Please read this prospectus carefully. It describes our company, finances, products, and services. Federal and state securities laws require us to include in this prospectus all the important information that you will need to make an investment decision.

You should rely only on the information contained or incorporated by reference in this prospectus to make your investment decision. We have not authorized anyone to provide you with different information. The selling shareholders are not offering these securities in any state where the offer is not permitted. You should not assume that the information in this prospectus is accurate as of any date other than the date on the front page of this prospectus.

Some of the statements contained in this prospectus, including statements under "Prospectus Summary," "Risk Factors," "Management's Discussion and Analysis of Financial Condition and Results of Operations," and "Business," are forward-looking and may involve a number of risks and uncertainties. Actual results and future events may differ significantly based upon a number of factors, including:

- we have had significant operating losses since starting business and we expect to continue losing money for some time;
- we expect competition from companies that are much larger and better financed than we are;
- we cannot be sure our products will be accepted in the marketplace; and
- we are in default on loans from three of our shareholders, and we are also in default under several of our equipment lease financing agreements.

In this prospectus, we refer to VirTra Systems, Inc. as "we" or "VirTra Systems," Dutchess Private Equities Fund II, L.P. as Dutchess II, and Dutchess Private Equities Fund, L.P and Dutchess Private Equities Fund II, L.P., collectively, as "Dutchess,

Prospectus Summary

This summary highlights information contained elsewhere in this prospectus. This summary is not complete and does not contain all of the information you should consider before investing in the common stock. You should read the entire prospectus carefully, including the "Risk Factors" section.

Our Business

Our principal business began in 1993 with the organization of Ferris Productions, Inc. Ferris designed, developed, distributed, and operated virtual reality products for the entertainment, simulation, promotion, and education markets.

Virtual reality is a generic term associated with computer systems that create a real-time visual/audio/haptic (touch and feel) experience. Virtual reality immerses participants into a three-dimensional real-time synthetic environment generated or controlled by one (or several) computer(s). In September of 2001, Ferris merged into GameCom, Inc., a publicly held Texas company whose principal business at the time was the development and marketing of an internet-enabled video game system. Our historic areas of application have included the entertainment/amusement, advertising/promotion, and training/simulation markets.

Our “*immersive virtual reality*™” devices are computer-based, and allow participants to view and manipulate graphical representations of physical reality. Stimulating the senses of sight, sound, touch, and smell simultaneously, our virtual reality devices envelop the participant in dynamic filmed or computer-generated imagery, and allow the participant to interact with what he or she sees using simple controls and body motions. Virtual reality products have traditionally employed head-mounted displays that combine high-resolution miniature image source monitors, wide field-of-view optics, and tracking sensors in a unit small and light enough to be worn on the head. These products usually surround the participant with dynamic three-dimensional imagery, allowing the user to change perspective on the artificial scenes by simply moving his or her head. Virtual reality devices have in

the past been used primarily in connection with electronic games, as, by surrounding the player with the sights, sounds, and smells he or she would experience in the real world, play is made far more realistic than it would be if merely presented in a two-dimensional flat screen display.

We maintain our corporate office at 440 North Center, Arlington, Texas 76011, and our telephone number is (817) 261-4269. We also maintain engineering, technical, and production offices, and a demonstration facility, at 5631 South 24th Street, Phoenix, Arizona 85040, with a phone number of (602) 470-1177.

The Offering

The selling shareholders are:

<u>Shareholder</u>	<u>Number of Shares</u>
Dutchess Private Equities Fund II, L.P. (1)	22,530,000
Dutchess Private Equities Fund, L.P. (1)	3,020,000
Gary Cella	75,000
Total	25,625,000

(1) The number of shares beneficially owned by holders of our convertible subordinated debentures is indeterminate as the conversion price of those debentures is based upon market price of the shares. In computing the numbers of shares held by these holders, the 6,800,000 million shares covered by this registration statement for resale following conversion have been divided proportionately to the principal amount of debentures held by each holder.

We have signed an investment agreement with Dutchess II to raise up to \$6 million through a series of sales of our common stock to Dutchess II. The dollar amount of each sale is limited by our common stock's trading volume. A minimum period of time must occur between sales. In turn, Dutchess II will either sell our stock in the open market, sell our stock to other investors through negotiated transactions, or hold our stock in its own portfolio. This prospectus covers the resale of our stock by Dutchess II either in the open market or to other investors. Under our equity line, we may, at our discretion, periodically sell to Dutchess II shares of our common stock for a total purchase price of up to \$6 million. It will pay us 94 percent of the lowest closing bid price of our common stock during the five trading days after we give notice to it of our demand - called a "put notice" - that it purchase a certain amount of our stock. It intends to resell any shares purchased under the equity line at the then-prevailing market price.

This prospectus also relates to 6,800,000 shares of our common stock that we have reserved for possible issuance to Dutchess as holders of three-year eight percent convertible debentures in the principal amount of \$750,000. The holders of these convertible debentures have the right to convert the debentures, with accrued interest, into shares of our common stock at the lesser of \$0.33 or 80 percent of the lowest closing bid price for our common stock during the 15 full trading days prior to the dates the holders give us their notices of conversion.

It also covers the resale of shares acquired or to be acquired by another investor as a result of an earlier private placement transaction. This shareholder has "piggyback" rights as to the registration statement that includes this prospectus.

Key Facts

Common Stock Offered	Up to 25,625,000 shares by selling shareholders. (1)
Offering Price	Prevailing market prices.
Common Stock Outstanding Before This Offering	60,859,064.

Use of Proceeds

None; however, we may receive up to \$6 million from the sale of the shares to Dutchess II, and we may receive additional amounts from the sale of shares to Dutchess if they exercise any of the warrants issued to them when they bought their convertible debentures. Those proceeds will be used for general corporate and working capital purposes.

Risk Factors

The securities offered involve a high degree of risk and immediate substantial dilution. See "Risk Factors" and "Dilution."

OTC Bulletin Board Common Stock Symbol

VTSI

(1) Includes

- up to 18,000,000 shares that we may issue to Dutchess II under the Investment Agreement,
- up to 6,800,000 shares that we may issue to Dutchess as the holders of our convertible subordinated debentures upon conversion of those debentures,
- up to 750,000 shares underlying warrants issued to Dutchess as the debenture investors,
- 75,000 shares we have issued in an earlier private placement transaction.

Summary Financial Data

The information below should be read together with "Management's Discussion and Analysis of Financial Condition and Results of Operations" and the financial statements and notes to financial statement included elsewhere in this prospectus.

	Year Ended December 31,	
	<u>2004</u>	<u>2003</u>
Revenue	\$ 1,328,180	\$ 984,490
Loss from operations	(2,352,535)	(588,615)
Net income (loss)	1,566,091	(1,590,122)
Income (loss) per common share	0.03	(0.04)
Weighted average number of common shares outstanding	51,675,342	42,415,964

Balance Sheet Data:

	December 31, 2004
Working capital (deficit)	(\$)

Total assets	1,452,966
Total liabilities	4,694,196
Shareholders' equity (deficit)	(3,241,230)

Risk Factors

An investment in the common stock the selling shareholders are offering to resell is risky. You should be able to bear a complete loss of your investment. Before purchasing any of the common stock, you should carefully consider the following risk factors, among others.

Risks Related to Our Business

We expect sales of our advertising and promotion virtual reality products to be strongly affected by general business trends.

Sales of our applications of virtual reality in the advertising and promotion fields are likely to be closely tied to the general level of business activity in the country, and particularly on the overall willingness of businesses to increase the amount they spend on advertising or promotion. Historically, in times of economic slowdown businesses have reduced their spending on advertising. Since custom applications for advertising generally carry a higher profit margin for us than our entertainment-related products and services, an overall decline in business activity could seriously reduce our margins and our prospects of becoming profitable.

Other companies with more resources and greater name recognition may make competition so intense that the business will not be profitable.

Although we have received a patent, have an exclusive license on a patent, and have several patent applications pending, covering our most valuable virtual reality technology in the training/simulation market, that patent, the license, and the other patents if issued, will provide only limited protection. They will not prevent other companies from developing virtual reality products similar to ours using other methods. If we are successful a number of other companies with far more money and greater name recognition may compete with us. That competition could exert downward pressure on the price we could charge for our products, making it more difficult for us to become profitable.

Our operating results may fluctuate significantly and may be difficult to predict.

Our operating results will likely fluctuate in the future due to a number of factors, many of which will be outside our control. These factors include:

- pricing competition;
- military and law enforcement budgets and budgeting cycles, which may fluctuate to to the effects of a wartime economy;
- the announcement or introduction of new and/or competing products in our markets; and
- the amount and timing of costs relating to expansion of our operations.

Due to these factors, factors discussed elsewhere in this document, or unforeseen factors in some future quarter, our operating results may not meet the expectations of securities analysts and investors, and if this happens, the trading price of the common stock of our company may decline.

The success of our new line of virtual reality training simulators will be affected by political considerations, such as the willingness of governmental agencies to spend additional amounts on our product to train military and law-enforcement personnel.

The major application of our new line of training simulators is the training military and law enforcement personnel. Although we have only recently unveiled these simulators within the past year, and have begun penetrating the market with sales to, among others, the U.S. Air Force, the U.S. Army, and the U.S. Department of Defense, we cannot give

any assurance that the interest will be long-lived, that funds will be made available to acquire or our products for that purpose, or that we will be selected to supply the training simulators. In addition, it is not uncommon for expected contracts for which we have incurred significant marketing costs to be delayed until the required funds have been appropriated. Delays in funding can severely reduce our ability to meet our obligations as they come due.

We cannot predict our future capital needs and we may not be able to secure additional financing.

To fully implement our current business plan, we will likely need to raise additional funds within the next 12 months in order to fund the operations of the company. While we expect that the majority of these funds will come from non-dilutive discounted purchase order financing, a substantial part of these funds may come from the sale of additional shares under our equity line arrangement with Dutchess II. However, for this to happen there must be a sustained volume of trading in our shares, since the amount we can draw under that line is directly related to our share price and volume. If we are unable to obtain contract financing, or to draw a sufficient amount under our arrangement with Dutchess II, we will need to seek financing from other sources. Whether we raise funds through our line of credit or other sources, you may experience significant dilution of your ownership interest, and these securities may have rights senior to the rights of common shareholders. If additional financing is not available when required or is not available on acceptable terms, we may be unable to fund continuing operations, develop our products, or take advantage of business opportunities or respond to competitive pressures, any of which could harm our business.

We expect our stock price to be volatile.

The market price of our common shares has been subject to wide fluctuations in response to several factors, such as:

- actual or anticipated variations in our results of operations;
- announcements of technological innovations;
- new services or product introductions by us or our competitors;
- changes in financial estimates by securities analysts; and
- conditions and trends in the training/simulation and advertising promotion fields.

The stock markets generally, and the OTC Bulletin Board in particular, have experienced extreme price and volume fluctuations that have particularly affected the market prices of equity securities of many technology companies, and that often have been unrelated or disproportionate to the operating performance of those companies. These market fluctuations, as well as general economic, political, and market conditions such as recessions, interest rates or international currency fluctuations, may adversely affect the market price of the common stock of the company.

We have had significant operating losses ever since starting business and we expect to continue losing money for some time.

To date, we have incurred significant losses. At December 31, 2004, our accumulated deficit was \$11,753,816 and our stockholders' deficit was \$3,241,230.

For the year ended December 31, 2004, although we showed net income of \$1,566,091, we actually lost \$2,352,535 from operations. These losses were caused primarily by the fact that our level of sales has been low compared to our general and administrative expenses. In order to become profitable, we will have to increase our revenues substantially. Based on our current projections, we do not expect to become profitable until promotional/advertising and training/simulation sales reach at least \$5,000,000 annually.

We depend heavily on the continued service of our chief executive officer and our president.

We place substantial reliance upon the efforts and abilities of L. Kelly Jones, our chief executive officer, and on the technical capabilities of Bob Ferris, our president. The loss of Mr. Jones's or Mr. Ferris's services could have a serious adverse effect on our business, operations, revenues, or prospects. We do not currently have an employment

agreement with either Mr. Jones or Mr. Ferris, or maintain any key man insurance on their lives, and we do not intend to maintain any key man insurance for the immediate future.

We are in default on certain equipment leases and shareholder promissory notes.

We previously operated virtual reality entertainment centers in a number of theme parks. We leased some of the equipment needed to operate these entertainment centers from approximately 140 leaseholders. In October of 2001 we told all of the leaseholders that we were suspending payments on their leases. Further, we previously had entered into promissory notes with approximately 14 shareholders. Although we were successful with a debt-to-equity conversion plan in December of 2004 with the holders of approximately 90% of the combined leaseholders/noteholders, we remain in default with the remainder. Litigation has been commenced against us by four leaseholders, and unless we are able to cure these defaults, settle the lawsuits, or prevail in the litigation, there is some possibility that we will be required to pay these obligations as judgments against us are received.

It is difficult to predict the impact of our proposed marketing efforts.

Our success will depend on adequate marketing resources. Our marketing plan includes attending trade shows and making private demonstrations, advertising and promotional materials, advertising campaigns in both print and broadcast media, cooperative marketing arrangements with the advertising industry, and other complimentary training/simulation and advertising/promotion-related operations. We cannot give any assurance that these marketing efforts will be successful.

Our management will have broad discretion in the use of proceeds we receive from the sale of shares to Dutchess II.

We will not receive any of the proceeds of this offering, but we may receive proceeds of the sale of shares to Dutchess II under our financing agreement with it. Management has broad discretion to adjust the application and allocation of the net proceeds of shares sold to Dutchess II in order to address changed circumstances and opportunities. As a result, our success will be substantially dependent upon the discretion and judgment of our management in determining how to apply and allocate those proceeds.

We do not expect to pay dividends for some time, if at all.

No dividends have been paid on the common stock. We expect that any income received from operations will be devoted to our future operations and growth. We do not expect to pay cash dividends in the near future. Payment of dividends would depend upon our profitability at the time, cash available for those dividends, and other factors.

A majority of our shareholders can elect all of our directors.

There is no cumulative voting for the election of our directors. As a result, the holders of a majority of our outstanding voting stock may elect all of our directors if they choose to do so, and the holders of the remaining shares will not be able to elect any directors. Currently, our officers and a consultant own a substantial percentage of the shares of common stock outstanding and are in a position to control our affairs, including the election of the board of directors.

Our business is subject to economic downturns to a greater extent than other companies' businesses might be.

Since we offer products and services that are generally considered discretionary, an economic downturn could have adverse consequences for us.

There is only a limited market for our shares.

While there is common stock that is "free trading," there is only a limited and relatively "thin" market for that common stock. We cannot give any assurance that an active public market will develop or be sustained. This means you might have difficulty liquidating your investment if that becomes necessary.

We may not have enough funding to complete our business plan.

We expect the major source of our operational funding over the next 36 months will be purchase order financing based on anticipated large military contracts. However, a major source of our investment funding may be our financing arrangement with Dutchess II. We also intend to require substantial up-front payments in our contracts for delivery of training simulators and custom advertising/promotional virtual reality applications. However, we may need additional financing to fully implement our business plan. We believe, in the absence of anticipated purchase order financing, that the Dutchess II private equity line will be sufficient to maintain our operations for at least the next 36 months, but the amount available under that line is based upon trading volume, which is beyond our control. If trading volume were to decline significantly, or not to increase as expected, we might not be able to draw down enough funds under that line to finance demand for our products. As a result, we may need to seek financing above that provided by Dutchess II's private equity line. We cannot give any assurance that this additional financing could be obtained on attractive terms, or at all. In addition, our ability to raise additional funds through a private placement may be restricted by SEC rules which limit a company's ability to sell securities similar to those being sold in a registered offering (such as that contemplated by Dutchess II's equity line) before that offering is completed or otherwise terminated. Lack of funding could force us to curtail substantially or cease our operations.

The market in which we compete is subject to rapid technological change.

Both virtual reality technology, and technology in the training/simulation and advertising/promotion markets, change rapidly, and our products and services, as well as the skills of our employees, could become obsolete quickly. Our success will depend, in part, on our ability to improve our existing products and develop new products that address the increasingly sophisticated and varied needs of our current and prospective customers, and respond to technological advances, emerging industry standards and practices, and competitive service offerings.

Our stock price is volatile.

The market price of our common stock has been and is likely to continue to be volatile and could be subject to wide fluctuations in response to quarterly variations in operating results, announcements of technological innovations or new products by us or our competitors, changes in financial estimates by securities analysts, overall equity market conditions or other factors that are mostly beyond our control. Because our stock is more volatile than the market as a whole, our stock is likely to be disproportionately harmed by factors that harm the general securities markets, such as economic turmoil and military or political conflict, even if those factors do not relate to our business. In the past, securities class action litigation has often been brought against companies after periods of volatility in the market price of their securities. If securities class action litigation is brought against us it could result in substantial costs and a diversion of management's attention and resources, which would hurt our business.

Trading in our common stock on the OTC Bulletin Board may be limited.

Our common stock trades on the OTC Bulletin Board. The OTC Bulletin Board is not an exchange and, because trading of securities on the OTC Bulletin Board is often more sporadic than trading of securities listed on an exchange such as AMEX or Nasdaq Small Cap, we intend to try to list our shares on one of those exchanges in the future.

However, we cannot give any assurance that an application for listing on either of such exchanges will be accepted. As a result, you may have difficulty reselling any of the shares that you purchase from the selling shareholders.

Our common stock is subject to penny stock regulation.

Our common stock is subject to regulations of the Securities and Exchange Commission relating to the market for penny stocks. These regulations generally require broker-dealers who sell penny stocks to persons other than established customers and accredited investors to deliver a disclosure schedule explaining the penny stock market and the risks associated with that market. These regulations also impose various sales practice requirements on broker-dealers. The regulations that apply to penny stocks may severely affect the market liquidity for our securities and that could limit your ability to sell your securities in the secondary market.

A significant percentage of our common stock is held by our directors and executive officers, who can significantly influence all actions that require a vote of our shareholders.

Our directors and executive officers currently own approximately 25.78 % of our outstanding common stock (including options to purchase 4,100,000 shares which have vested), and have an unvested option on an additional 1,000,000 shares. As a result, management is in a position to influence significantly the election of our directors and all other matters that are put to a vote of our shareholders.

The exercise of options and warrants could depress our stock price and reduce your percentage of ownership.

In addition to the 1,250,000 warrants held by Dutchess and the 496,703 contested warrants held by Swartz, our directors and officers hold options to buy our shares, as indicated above. In the future, we may grant more warrants or options under stock option plans or otherwise. The exercise or conversion of stock options, warrants, or other convertible securities that are presently outstanding, or that may be granted in the future, will dilute the percentage ownership of our other shareholders. The "Description of Securities" section of this prospectus provides you with more information about options and warrants to purchase our common stock that will be outstanding after this offering.

Risks Related to This Offering

Future sales by our shareholders may reduce our stock price and make it more difficult for us to raise funds in new stock offerings.

Sales of our common stock in the public market following this offering could lower the market price of our common stock. Sales may also make it more difficult for us to sell equity securities or equity-related securities in the future at a time and price that our management deems acceptable or even to sell these securities at all. Of the 60,859,064 shares of common stock outstanding as of March 25, 2005, 22,254,494 shares of common stock held by existing shareholders are restricted securities and may be resold in the public market only if registered or pursuant to an exemption from registration. Some of these shares may be resold under Rule 144. Immediately following the effective date of this prospectus, and not including the shares to be issued under the equity line or the shares to be issued upon conversion of the convertible debentures, shares of common stock would be freely tradable without restriction, unless held by our affiliates.

If all shares registered in this offering are resold in the public market, there will be an additional 25,625,000 shares of common stock outstanding. The holders of our convertible debentures will be able to convert and sell at any time after the accompanying registration statement becomes effective. When the registration statement becomes effective investors under our equity line will be able to resell the shares they buy from us as soon as they buy them.

Existing shareholders will experience significant dilution from our sale of shares under the equity line and the conversion of the convertible debentures to stock.

The sale of shares under our equity line and the conversion of the convertible debentures to shares of common stock will dilute our shareholders. As a result, our net income per share could decrease in future periods, and the market price of our common stock could decline. In addition, the lower our stock price is, the more shares of common

stock we will have to issue through conversion of our convertible debentures to common stock and under the equity line to draw down the full amount. The lower our stock price, the greater the dilution will be for our existing shareholders. The higher our stock price, the greater the dilution will be for new shareholders.

The holders of the convertible debentures will be able to convert their debentures to shares of common stock at conversion values less than the then-prevailing market price of our common stock. And investors under the equity line will pay less than the then-prevailing market price of our common stock.

The common stock we issue upon conversion of our convertible debentures will be issued at values at least 20 percent lower than the lowest closing bid price for our common stock during the 15 trading days before the date we get notice of a conversion. The common stock to be issued under the equity line will be issued at a six percent discount to the lowest closing bid price of our common stock during the five trading days after we give notice to them of our "put." These discounted conversion prices and sales could cause the price of our common stock to decline.

The selling shareholders intend to sell their shares of common stock in the market, and those sales may cause our stock price to decline.

The selling shareholders intend to sell in the public market the shares of common stock being registered in this offering. That means that up to 25,625,000 shares of our common stock, the number of shares being registered in this offering, may be sold. Those sales may cause our stock price to decline.

The price you pay in this offering will fluctuate.

The price in this offering will fluctuate based on the prevailing market price of the common stock on the OTC Bulletin Board. Accordingly, the price you pay in this offering may be higher or lower than the prices paid by other people participating in this offering.

We may not be able to draw down enough money under the equity line when needed.

We depend on external financing to fund our operations. Our financing needs are expected to be provided from the equity line, in large part. As the market price and volume decline, the amount of financing available under the equity line will decline. As a result, we may not be able to draw down enough money under the equity line, or to draw it down quickly enough, to meet our financing needs.

Selling Shareholders

The following table presents information regarding the selling shareholders. Under the equity line, Dutchess II has agreed to purchase up to \$6 million of common stock from us. All Dutchess II's investment decisions are made by Dutchess Capital Management, LLC, of which Michael A. Novielli and Douglas H. Leighton are the managing members. Neither Dutchess II nor its agents has a short position or has had a short position at any time since the investment agreement for the equity line was executed on February, 25, 2005. None of the selling shareholders has held a position or office, or had any other material relationship, with us.

Selling Security Holder	Shares Beneficially	Percentage of Outstanding	Shares to be Acquired	Percentage of Outstanding	Shares to be Sold in	Percentage of Outstanding
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Owned Before Offering	Shares Beneficially Owned Before Offering	Under Equity Line of Credit	Shares to be Acquired Under Equity Line of Credit	Offering	Shares Beneficially Owned After Offering
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Dutchess Private
Equities Fund, II L.P.

(1)(2)	4,530,000	6.9%	18,000,000	22.8%	22,530,000	-
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Dutchess Private
Equities Fund L.P.

(2)(3)	3,020,000	4.7%			3,020,000	-
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Gary Cella	200,000	0.3%			75,000	0.1%
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(1) Includes 450,000 shares issuable on exercise of warrants and 4,080,000 shares issuable upon conversion of convertible subordinated debentures

(2) The number of shares beneficially owned by holders of our convertible subordinated debentures is indeterminate as the conversion price of those debentures is based upon market price of the shares. In computing the numbers of shares held prior to the offering by holders of convertible subordinated debentures, we have assumed that the applicable conversion price will be \$0.33. We are registering additional shares for this offering because the conversion price may be lower than that assumed price. As a result, the numbers of shares shown in this table do not correspond to those shown under the caption "The Offering."

Dutchess Capital Management, Inc. serves as general partner to both Dutchess funds. Michael A. Novielli and Douglas H. Leighton serve as managing members of Dutchess Capital Management, Inc.

(3) Includes 300,000 shares issuable on exercise of warrants and 2,720,000 shares issuable upon conversion of convertible subordinated debentures.

Use of Proceeds

We will not receive any proceeds from the sale of the shares by the selling securityholders. However, we may receive additional proceeds from the sale to Dutchess of shares issuable upon the exercise of warrants issued in connection with the convertible debentures. We intend to use the proceeds from the sale of the shares to Dutchess II and the exercise of warrants by Dutchess for working capital and general corporate purposes.

Dilution

Our net tangible book value as of December 31, 2004 was \$(3,437,453) or \$(0.06) per share of our common stock. Net tangible book value per share is determined by dividing our tangible book value (total tangible assets less total liabilities) by the number of outstanding shares of our common stock. Net tangible book value as of December 31, 2004 is calculated by subtracting our net intangible assets of \$196,223 from net total book value (total assets less total liabilities) of \$(3,241,230). Since this offering is being made solely by the selling stockholders and none of the proceeds will be paid to us, our net tangible book value will be unaffected by this offering. Our net tangible book value, however, will be impacted by the common stock to be issued by Dutchess II under the investment agreement, and by the warrants issued to Dutchess. The amount of dilution resulting from share issuances to Dutchess II under the investment agreement will be determined by our stock price at or near the time of each "put" by us.

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The amount of dilution resulting from share issuances to Dutchess will also depend on whether all or a portion of the warrant is exercised. The following example shows the dilution to new investors assuming: (i) no exercise of the warrants issued to Dutchess, and (ii) the issuance of 100%, 50%, 25%, and 10% of the 18,000,000 shares of our common stock at an assumed adjusted offering price of \$.291 per share (which is based on the closing price of our common stock on March 24, 2005, of \$0.31 per share). The discount is defined as 94% of the lowest closing bid price of our common stock during the five consecutive trading day period immediately following our notice to Dutchess II of each election to exercise our "put" right.

Assumed % of shares issued	100%	50%	25%	10%
Number of shares	18,000,000	9,000,000	4,500,000	1,800,000

Current stock price	0.31	0.31	0.31	0.31
Assumed exercise price	0.291	0.291	0.291	0.291
Total proceeds	5,245,200	2,622,600	1,311,300	524,520
Net tangible book value prior to offering	(3,437,453)	(3,437,453)	(3,437,453)	(3,437,453)
Net tangible book value after offering	1,807,747	(814,853)	(2,126,153)	(2,912,933)
Net tangible book value per share prior to offering	(0.06)	(0.06)	(0.06)	(0.06)
Net tangible book value per share after offering	0.023	(0.012)	(0.033)	(0.046)
Dilution of new investors	0.287	0.322	0.343	0.356
Accretion to existing stockholders	0.079	0.045	0.024	0.010

You should be aware that there is an inverse relationship between our stock price and the number of shares to be issued under the investment agreement and the \$750,000 convertible debentures held by Dutchess. As our stock price declines, we would be required to issue a greater number of shares for a given advance under the equity line or conversion of the debentures, as the case may be. This inverse relationship is demonstrated by the table below, which shows the number of shares to be issued under the investment agreement at \$0.291 per share, and the number of shares issued under the \$750,000 convertible debentures held by Dutchess at a price of \$0.33 per share, and at 25%, 50%, and 75% discounts to those prices.

% discount	0%	25%	50%	75%
Conversion price	0.33(1)	0.2475	0.165	0.0825
Assumed sale price (2)	0.31(2)	0.2325	0.155	0.0775
Assumed "put" price (3)	0.2914	0.21855	0.1457	0.07285
Shares issued pursuant to "put" right (4)	20,590,254	27,453,672	41,180,508	82,361,016
Shares upon conversion of note payable (5)	2,272,727	3,030,303	4,545,455	9,090,909
Total outstanding (6)	83,722,045	91,343,039	106,585,026	152,310,989
% outstanding (7)	27%	33%	43%	60%

(1) Represents the fixed conversion price of the \$750,000 convertible debentures held by Dutchess

(2) Represents the price of our common stock on March 24, 2005.

(3) Represents the 94% discounted price as set forth in the investment agreement.

(4) Represents the number of shares of our common stock to be issued at the prices set forth in the table upon our exercise of the "put" right under the investment agreement.

(5) Represents the number of shares of our common stock to be issued at the prices set forth in the table upon conversion of the \$750,000 convertible debentures.

(6) Represents the total number of shares of our common stock outstanding after the issuance of shares from footnote (4) and (5) above, assuming no issuances of any other shares of our common stock.

(7) Represents the shares of our common stock to be issued as a percentage of the total number of shares of our common stock outstanding (assuming no exercise or conversion of any options, warrants or other convertible securities).

Capitalization

The following table shows our total capitalization as of December 31, 2004.

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Common stock, \$0.005 par value; 100,000,000 shares authorized, 60,438,152 issued and outstanding	\$ 302,191
Additional paid-in capital	8,210,395
Accumulated deficit	(11,753,816)
Total capitalization)

Equity line

Under our equity line, we may, at our discretion, periodically issue and sell shares of our common stock to Dutchess II for a possible maximum purchase price of \$6.0 million. If we issue a "put notice" under the equity line, the put number may be for a definable number of shares of our common stock at a per-share purchase price equal to 94 percent of the lowest closing bid price on the OTC Bulletin Board, or other principal market on which our common stock is traded, for the five trading days immediately following the notice date. However, the amount of shares we can require Dutchess II to purchase is limited to the greater of a) 200% of the average daily volume of our common stock for the 10 trading days prior to the applicable put notice date, multiplied by the average of the three daily closing bid prices immediately preceding the put date; or b) \$50,000; provided however, that the put amount can never exceed \$1,000,000 with respect to any single put. Dutchess II intends to sell any shares it purchases under the equity line at the market price. This prospectus primarily relates to the shares of common stock to be issued to Dutchess II under the equity line. Dutchess II cannot transfer its interest in the equity line to anyone else.

In order to draw on the equity line, we must register the shares of common stock with the Securities and Exchange Commission and keep the registration statement effective.

Mechanics

We may, at our discretion, issue written put notices to Dutchess II specifying the dollar amount up to the maximum put amount. A closing will be held seven trading days after each written put notice. At each closing we will deliver shares of common stock and Dutchess II will pay the put notice amount. We determine when and if we want to issue a put notice.

Open Period

We may issue a put notice at any time during the open period but not more frequently than every 7 trading days. The open period begins on the date the Securities and Exchange Commission first declares the accompanying registration statement effective. It expires on the earlier of (i) the date on which Dutchess II has made advances totaling \$6.0 million, or (ii) 36 months after the registration statement becomes effective.

Purchase Price

For each five-day purchase period starting with our issuance of a put notice, Dutchess II will purchase shares of common stock from us at a price equal to 94 percent of the lowest closing bid price for our common stock during the five-day period..

Maximum Put Notice Amount

We may not issue put notices in excess of a total of \$6.0 million. In addition, each individual put notice is subject to a maximum amount based on an average daily volume of our common stock. The maximum amount of each put notice is equal to the greater of a) 200% of the average daily volume of our common stock for the 10 trading days prior to the applicable put notice date, multiplied by the average of the three daily closing bid prices immediately preceding the put date; or b) \$50,000; provided however, that the put amount can never exceed \$1,000,000 with respect to any single put.

Maximum Amount Subject to Each Put Notice

Regardless of the amount stated in a put notice, the maximum amount of our common stock that Dutchess II is required to purchase is determined by a different formula. It is required to purchase the lesser of the amount stated in the put notice or an amount equal to 20 percent of the aggregate trading volume of our stock during the five days commencing with the date of delivery of the put notice times the lowest closing bid prices for our common stock during the five-day period.

By way of illustration only, let us assume that the 10-day average trading volume in our common stock is 50,000 shares during the 10 trading days prior to our issuing a put notice, and that the average closing bid price for our common stock is \$0.40 during the three trading days prior to our issuing this put notice. Let us also assume that the aggregate (not average) trading volume is 200,000 shares during the five trading days after we issue the put notice, and that the lowest closing bid prices for our common stock is \$0.30 during this five-day period. The result would be that our maximum allowable put notice would be in the amount of \$ $(2 \times 50,000 \times \$0.40 = \$)$, but the maximum amount of stock Dutchess II would have to buy at \$0.28 per share $(.94 \times \$0.30)$ is 40,000 shares $(.20 \times 200,000)$, and the dollar amount we would receive for that stock would be \$ $(40,000 \times \$0.28)$.

Using our average trading volume (123,657 shares) and stock price information (\$0.328 per share) from the 60 days just before the accompanying registration statement was filed, we would be able to give put notices for approximately \$81,119 every seven trading days from the effective date of the registration statement during the next 36 months. And if trading volume and price remained the same during the five days after the put notice, Dutchess II would be required to buy \$38,126 of common stock after each put. This would result in our receiving an aggregate of approximately \$4,166,627 under the equity line.

Cancellation of Puts

We may withdraw that portion of any put notice amount if the then-current market price of our shares for that put does not meet the Minimum Acceptable Price. For purposes of our equity line investment agreement, the Minimum Acceptable Price is a price equal to 75% of the average closing bid price for the 10 trading days prior to the date of the put notice. If we cancel a put notice, we will still be required to sell Dutchess II the number of shares Dutchess II sold during the time from the day it received the put notice until it received the notice of cancellation.

Number of Shares to Be Issued

We cannot determine the actual number of shares of common stock that we will issue under the equity line. In part this is because the purchase price of the shares will fluctuate based on prevailing market conditions and we have not determined the total amount we intend to draw. Nonetheless, we can estimate the number of shares of common stock that would be issued using certain assumptions. Assuming we drew down the entire \$6.0 million available under the equity line and the purchase price was equal to \$0.30 per share (which would be 94 percent of the lowest closing bid price during the five days commencing with our issuance of a put notice), then we would issue shares of common stock to Dutchess II. These shares would represent 24.7 percent of our outstanding capital stock upon issuance. To help investors evaluate the number of shares of common stock we might issue to Dutchess II at various prices, we have prepared the following table. This table shows the number of shares of our common stock that we would issue at various prices.

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Purchase Price:	\$0.20	\$0.30	\$0.60	\$0.90	\$1.20
Number of Shares(1):	30,000,000	20,000,000	10,000,000	6,666,667	5,000,000
Total Outstanding(2):	90,859,064	80,859,064	70,859,064	67,525,731	65,859,064
Percent Outstanding(3):	33.0%	24.7%	14.1%	9.9%	7.6%

(1) Represents the number of shares of common stock to be issued to Dutchess II at the prices set forth in the table.

(2) Represents the total number of shares of common stock outstanding after the issuance of the shares to Dutchess II.

(3) Represents the shares of common stock to be issued as a percentage of the total number of shares outstanding.

Shareholder Approval

Under the investment agreement, we may sell Dutchess II a number of shares that is more than 20% of our shares outstanding on the date of this prospectus. If we become listed on The Nasdaq Small Cap Market or Nasdaq National Market, we may be required to get shareholder approval to issue some or all of the shares to Dutchess II. As we are currently an OTC Bulletin Board company, we do not need shareholder approval.

Registration Rights

We granted registration rights to Dutchess II for its shares and to Dutchess as the holders of our convertible subordinated debentures for the shares they may receive if they convert the debentures. We had previously granted piggyback registration rights to a shareholder who previously purchased our common stock in a private offering.

The registration statement that includes this prospectus will register all of those shares when it becomes effective. We will bear the cost of the registration.

Dutchess's Right to Indemnification

We have agreed to indemnify Dutchess (including its shareholders, officers, directors, employees, investors, and agents) from all liability and losses resulting from any misrepresentations or breaches we make in connection with the investment agreement, our registration rights agreement, other related agreements, or the registration statement.

Right of First Refusal

Dutchess II has a right of first refusal to participate in any below-market private capital raising transaction of equity securities that closes from the date of the investment agreement (February 25, 2005) through one year after this registration statement becomes effective.

Net Proceeds

We cannot predict the total amount of proceeds we will raise in this transaction. This is partly because we have not determined the total amount of put notices we intend to issue. However, we expect to incur expenses of approximately \$15,937 consisting primarily of professional fees incurred in connection with registering 25,625,000 shares in this offering.

Plan of Distribution

The selling shareholders have each told us they intend to sell the common stock covered by this prospectus from time to time on the OTC Bulletin Board market, or in any other market where our shares of common stock are quoted. The selling shareholders, and any brokers, dealers, or agents that participate in the distribution of the common stock, may be deemed to be underwriters, and any profit on the sale of common stock by them and any discounts, concessions, or

commissions they receive may be deemed to be underwriting discounts and commissions under the Securities Act.

Dutchess II is an underwriter within the meaning of the Securities Act of 1933 in connection with the sale of common stock under the equity line agreement. Dutchess II will buy stock from us at a purchase price of 94 percent of the lowest closing bid price of our common stock on the OTC Bulletin Board or other principal trading market on which our common stock is traded for the five trading days immediately following each put notice date. Under the securities laws of some states, the shares of common stock may be sold in such states only through registered or licensed brokers or dealers. We will inform the selling shareholders that any underwriters, brokers, dealers, or agents effecting transactions on behalf of the selling shareholders must be registered to sell securities in all 50 states.

In addition, in some states the shares of common stock may not be sold unless the shares have been registered or qualified for sale in such state or an exemption from registration or qualification is available and is complied with.

We will pay all the expenses of the registration, offering, and sale of the shares of common stock to the public under this prospectus other than commissions, fees, and discounts of underwriters, brokers, dealers, and agents. We have agreed to indemnify the selling shareholders and their controlling persons against certain liabilities, including liabilities under the Securities Act. We estimate that the expenses of the offering to be borne by us will be approximately \$15,937. We will not receive any proceeds from the sale of any of the shares of common stock by the selling shareholders. We will, however, receive proceeds from the sale of common stock under the equity line.

The selling shareholders should be aware that the anti-manipulation provisions of Regulation M under the Exchange Act will apply to purchases and sales of shares of common stock by the selling shareholders and that there are restrictions on market-making activities by persons engaged in the distribution of the shares. Under Regulation M, the selling shareholders or their agents may not bid for, purchase, or attempt to induce any person to bid for or purchase, shares of our common stock while they are distributing shares covered by this prospectus. Accordingly, except as noted below, the selling shareholders are not permitted to cover short sales by purchasing shares while the distribution is taking place. Dutchess II can cover any short positions only with shares received from us under the equity line. We will advise the selling shareholders that if a particular offer of common stock is to be made on terms materially different from the information set forth in the above Plan of Distribution, then a post-effective amendment to the accompanying registration statement must be filed with the Securities and Exchange Commission.

We engaged Institutional Capital Management, Inc., of Houston, Texas, as our exclusive placement agent under the equity line of credit. To our knowledge, ICM has no affiliation or business relationship with Dutchess II. We agreed to pay ICM one percent of the gross proceeds from each put, with an aggregate maximum of \$10,000, over the term of our equity line of credit agreement with Dutchess II. Our placement agent agreement with ICM terminates when our investment agreement with Dutchess II terminates.

Price Range of Common Stock

Our common stock is quoted under the symbol "VTSI" on the OTC Electronic Bulletin Board. The following table sets forth the high and low bid prices for shares of our common stock for 2002, 2003, and 2004, and the first quarter of 2005 through March 24, 2005, as reported by the OTC Electronic Bulletin Board. Quotations reflect inter dealer prices, without retail markup, mark down, or commission, and may not represent actual transactions.

YEAR

PERIOD H

Note 4: Financial Instruments

Our financial instruments consist of cash and cash equivalents, accounts receivable, accounts payable, debt and an interest rate swap. The carrying amounts of cash and cash equivalents, accounts receivable and accounts payable approximate fair value due to the short-term maturity of these instruments.

Our debt consists of outstanding principal under our revolving credit agreement (the Credit Agreement), our 6.25% senior notes due 2015 (the 6.25% Senior Notes) and our 8.25% senior notes due 2018 (the 8.25% Senior Notes). The \$157 million carrying amount of outstanding debt under our Credit Agreement at September 30, 2010, approximates fair value as interest rates are reset frequently using current rates. The estimated fair values of our 6.25% Senior Notes and 8.25% Senior Notes were \$183.2 million and \$156.8 million, respectively, at September 30, 2010. These fair value estimates are based on market quotes provided from a third-party bank. See Note 8 for additional information on these instruments.

Fair Value Measurements

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

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

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

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

We have an interest rate swap that is measured at fair value on a recurring basis using Level 2 inputs that as of September 30, 2010 represented a liability having a fair value of \$11.8 million. With respect to this instrument, fair value is based on the net present value of expected future cash flows related to both variable and fixed rate legs of our interest rate swap agreement. Our measurement is computed using the forward London Interbank Offered Rate (LIBOR) yield curve, a market-based observable input. See Note 8 for additional information on our interest rate swap.

Table of Contents**Note 5: Properties and Equipment**

	September 30, 2010	December 31, 2009
	(In thousands)	
Pipelines and terminals ⁽¹⁾	\$ 493,182	\$ 455,075
Land and right of way	25,257	25,230
Other	13,926	12,528
Construction in progress	14,417	10,484
	546,782	503,317
Less accumulated depreciation	121,976	105,273
	\$ 424,806	\$ 398,044

(1) We periodically evaluate estimated useful lives of our properties and equipment. Effective January 1, 2010, we revised the estimated useful lives of our terminal assets to 16 to 25 years. This change in estimated useful lives resulted in a \$2.2 million reduction in depreciation expense for the nine months ended September 30, 2010.

We capitalized \$0.4 million and \$0.9 million in interest related to major construction projects during the nine months ended September 30, 2010 and 2009, respectively.

Note 6: Transportation Agreements

Our transportation agreements consist of the following:

The Alon pipelines and terminals agreement (the "Alon PTA") represents a portion of the total purchase price of the Alon assets acquired in 2005 that was allocated based on an estimated fair value derived

under an income approach. This asset is being amortized over 30 years ending 2035, the 15-year initial term of the Alon PTA plus the expected 15-year extension period.

The Holly crude pipelines and tankage agreement (the Holly CPTA) represents a portion of the total purchase price of certain crude pipelines and tankage assets acquired from Holly in 2008 that was allocated using a fair value based on the agreement's expected contribution to our future earnings under an income approach. This asset is being amortized over 15 years ending 2023, the 15-year term of the Holly CPTA.

The carrying amounts of our transportation agreements are as follows:

	September 30, 2010	December 31, 2009
	(In thousands)	
Alon transportation agreement	\$ 59,933	\$ 59,933
Holly crude pipelines and tankage agreement	74,231	74,231
	134,164	134,164
Less accumulated amortization	23,938	18,728
	\$ 110,226	\$ 115,436

We have additional transportation agreements with Holly that relate to pipeline, terminal and tankage assets contributed to us or acquired from Holly. These transfers occurred while under common control of Holly, therefore, our basis in these assets reflect Holly's historical cost and does not reflect a step-up in basis to fair value. These agreements have a recorded value of zero.

In addition, we have an agreement to provide transportation and storage services to Holly via our Tulsa logistics and storage assets acquired from Sinclair. Since this agreement is with Holly and not between Sinclair and us, there is no cost attributable to this agreement.

Table of Contents**Note 7: Employees, Retirement and Incentive Plans**

Employees who provide direct services to us are employed by Holly Logistic Services, L.L.C., a Holly subsidiary. Their costs, including salaries, bonuses, payroll taxes, benefits and other direct costs are charged to us monthly in accordance with an omnibus agreement that we have with Holly. These employees participate in the retirement and benefit plans of Holly. Our share of retirement and benefit plan costs was \$0.8 million for the three months ended September 30, 2010 and 2009 and \$2.1 million and \$2 million for the nine months ended September 30, 2010 and 2009, respectively.

We have adopted an incentive plan (Long-Term Incentive Plan) for employees, consultants and non-employee directors who perform services for us. The Long-Term Incentive Plan consists of four components: restricted units, performance units, unit options and unit appreciation rights.

As of September 30, 2010, we have two types of equity-based compensation, which are described below. The compensation cost charged against income for these plans was \$0.4 million and \$0.2 million for the three months ended September 30, 2010 and 2009, respectively, and \$1.8 million and \$1.1 million for the nine months ended September 30, 2010 and 2009, respectively. We currently purchase units in the open market instead of issuing new units for settlement of restricted unit grants. At September 30, 2010, 350,000 units were authorized to be granted under the equity-based compensation plans, of which 169,939 had not yet been granted.

Restricted Units

Under our Long-Term Incentive Plan, we grant restricted units to selected employees and directors who perform services for us, with vesting generally over a period of one to five years. Although full ownership of the units does not transfer to the recipients until the units vest, the recipients have distribution and voting rights on these units from the date of grant. The fair value of each restricted unit award is measured at the market price as of the date of grant and is amortized over the vesting period.

A summary of restricted unit activity and changes during the nine months ended September 30, 2010 is presented below:

Restricted Units	Grants	Weighted-Average Grant-Date Fair Value	Weighted-Average Remaining Contractual Term	Aggregate Intrinsic Value (\$000)
Outstanding at January 1, 2010 (nonvested)	53,271	\$ 34.31		
Granted	36,755	43.13		
Vesting and transfer of full ownership to recipients	(41,505)	38.53		
Forfeited	(1,226)	34.28		
Outstanding at September 30, 2010 (nonvested)	47,295	\$ 37.47	0.9 year	\$ 2,424

The fair value of restricted units that were vested and transferred to recipients during the nine months ended September 30, 2010 and 2009 were \$1.6 million and \$1.2 million, respectively. As of September 30, 2010, there was \$0.7 million of total unrecognized compensation costs related to nonvested restricted unit grants. That cost is expected to be recognized over a weighted-average period of 0.9 year.

During the nine months ended September 30, 2010, we paid \$2.3 million for the purchase of 53,952 of our common units in the open market for the recipients of our restricted unit grants.

Table of Contents***Performance Units***

Under our Long-Term Incentive Plan, we grant performance units to selected executives who perform services for us. Performance units granted in 2010 are payable based upon the growth in our distributable cash flow per common unit over the performance period, and vest over a period of three years. Performance units granted in 2009 and 2008 are payable based upon the growth in distributions on our common units during the requisite period, and vest over a period of three years. As of September 30, 2010, estimated share payouts for outstanding nonvested performance unit awards ranged from 110% to 120%.

We granted 16,965 performance units to certain officers in March 2010. These units will vest over a three-year performance period ending December 31, 2012 and are payable in HEP common units. The number of units actually earned will be based on the growth of our distributable cash flow per common unit over the performance period, and can range from 50% to 150% of the number of performance units granted. The fair value of these performance units is based on the grant date closing unit price of \$42.59 and will apply to the number of units ultimately awarded.

A summary of performance unit activity and changes during the nine months ended September 30, 2010 is presented below:

Performance Units	Payable In Units
Outstanding at January 1, 2010 (nonvested)	54,771
Granted	16,965
Vesting and transfer of common units to recipients	(11,785)
Forfeited	(536)
Outstanding at September 30, 2010 (nonvested)	59,415

The fair value of performance units vested and transferred to recipients during the nine months ended September 30, 2010 and 2009 was \$0.5 million and \$0.4 million, respectively. Based on the weighted average fair value at September 30, 2010 of \$32.97, there was \$1 million of total unrecognized compensation cost related to nonvested performance units. That cost is expected to be recognized over a weighted-average period of 1.3 years.

Note 8: Debt***Credit Agreement***

We have a \$300 million senior secured revolving Credit Agreement expiring in August 2011. The Credit Agreement is available to fund capital expenditures, acquisitions, and working capital and for general partnership purposes. In addition, the Credit Agreement is available to fund letters of credit up to a \$50 million sub-limit and to fund distributions to unitholders up to a \$20 million sub-limit. Advances under the Credit Agreement that are designated for working capital are classified as short-term liabilities. Other advances under the Credit Agreement, including advances used for the financing of capital projects, are classified as long-term liabilities. During the nine months ended September 30, 2010, we received advances totaling \$52 million and repaid \$101 million, resulting in the net repayment of \$49 million in advances. As of September 30, 2010, we had \$157 million outstanding under the Credit Agreement that was used to finance acquisitions and capital projects. The Credit Agreement expires in August 2011; therefore, outstanding borrowings, all of which were previously classified as long-term liabilities, are currently classified as current liabilities. We intend to renew the credit agreement prior to expiration and to continue to finance outstanding credit agreement borrowings. Upon renewal of the Credit Agreement, outstanding borrowings not designated for working capital purposes will be reclassified as long-term debt.

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

our wholly-owned subsidiaries. Any recourse to HEP Logistics Holdings, L.P. would be limited to the extent of its assets, which other than its investment in us, are not significant.

- 13 -

Table of Contents

We may prepay all loans at any time without penalty, except for payment of certain breakage and related costs. We are required to reduce all working capital borrowings under the Credit Agreement to zero for a period of at least 15 consecutive days in each twelve-month period prior to the maturity date of the agreement. As of September 30, 2010, we had no working capital borrowings.

Indebtedness under the Credit Agreement bears interest, at our option, at either (a) the reference rate as announced by the administrative agent plus an applicable margin (ranging from 0.25% to 1.50%) or (b) at a rate equal to LIBOR plus an applicable margin (ranging from 1.00% to 2.50%). In each case, the applicable margin is based upon the ratio of our funded debt (as defined in the Credit Agreement) to EBITDA (earnings before interest, taxes, depreciation and amortization, as defined in the Credit Agreement). At September 30, 2010, we were subject to an applicable margin of 1.75%. We incur a commitment fee on the unused portion of the Credit Agreement at a rate ranging from 0.20% to 0.50% based upon the ratio of our funded debt to EBITDA for the four most recently completed fiscal quarters. At September 30, 2010, we are subject to a .30% commitment fee on the \$143 million unused portion of the Credit Agreement.

The Credit Agreement imposes certain requirements on us, including: a prohibition against distribution to unitholders if, before or after the distribution, a potential default or an event of default as defined in the agreement would occur; limitations on our ability to incur debt, make loans, acquire other companies, change the nature of our business, enter a merger or consolidation, or sell assets; and covenants that require maintenance of a specified EBITDA to interest expense ratio and debt to EBITDA ratio. If an event of default exists under the Credit Agreement, the lenders will be able to accelerate the maturity of the debt and exercise other rights and remedies.

Additionally, the Credit Agreement contains certain provisions whereby the lenders may accelerate payment of outstanding debt under certain circumstances.

Senior Notes

In March 2010, we issued \$150 million in aggregate principal amount of 8.25% Senior Notes maturing March 15, 2018. A portion of the \$147.5 million in net proceeds received was used to fund our \$93 million purchase of the Tulsa and Lovington storage assets from Holly on March 31, 2010. Additionally, we used a portion to repay \$42 million in outstanding Credit Agreement borrowings, with the remaining proceeds available for general partnership purposes, including working capital and capital expenditures.

Our 6.25% Senior Notes having an aggregate principal amount of \$185 million mature March 1, 2015 and are registered with the SEC. The 6.25% Senior Notes and 8.25% Senior Notes (collectively, the Senior Notes) are unsecured and have certain restrictive covenants, which we are subject to and currently in compliance with, including limitations on our ability to incur additional indebtedness, make investments, sell assets, incur certain liens, pay distributions, enter into transactions with affiliates, and enter into mergers. At any time when the Senior Notes are rated investment grade by both Moody's and Standard & Poor's and no default or event of default exists, we will not be subject to many of the foregoing covenants. Additionally, we have certain redemption rights under the Senior Notes.

Indebtedness under the Senior Notes is recourse to HEP Logistics Holdings, L.P., our general partner, and guaranteed by our wholly-owned subsidiaries. However, any recourse to HEP Logistics Holdings, L.P. would be limited to the extent of its assets, which other than its investment in us, are not significant.

Table of Contents

The carrying amounts of our debt are as follows:

	September 30, 2010	December 31, 2009
	(In thousands)	
Credit Agreement	\$ 157,000	\$ 206,000
6.25% Senior Notes		
Principal	185,000	185,000
Unamortized discount	(1,679)	(1,964)
Unamortized premium dedesignated fair value hedge	1,531	1,791
	184,852	184,827
8.25% Senior Notes		
Principal	150,000	
Unamortized discount	(2,288)	
	147,712	
Total debt	489,564	390,827
Less credit agreement borrowings classified as current liabilities	157,000	
Total long-term debt	\$ 332,564	\$ 390,827

Interest Rate Risk Management

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

As of September 30, 2010, we have an interest rate swap that hedges our exposure to the cash flow risk caused by the effects of LIBOR changes on a \$155 million Credit Agreement advance. This interest rate swap effectively converts \$155 million of LIBOR based debt to fixed rate debt having an interest rate of 3.74% plus an applicable margin, currently 1.75%, which equals an effective interest rate of 5.49% as of September 30, 2010. The maturity date of this swap contract is February 28, 2013.

We have designated this interest rate swap as a cash flow hedge. Based on our assessment of effectiveness using the change in variable cash flows method, we have determined that this interest rate swap is effective in offsetting the variability in interest payments on our \$155 million variable rate debt resulting from changes in LIBOR. Under hedge accounting, we adjust our cash flow hedge on a quarterly basis to its fair value with the offsetting fair value adjustment to accumulated other comprehensive loss. Also on a quarterly basis, we measure hedge effectiveness by comparing the present value of the cumulative change in the expected future interest to be paid or received on the variable leg of our swap against the expected future interest payments on our \$155 million variable rate debt. Any ineffectiveness is reclassified from accumulated other comprehensive loss to interest expense. To date, we have had no ineffectiveness on our cash flow hedge.

Additional information on our interest rate swap as of September 30, 2010 is as follows:

Balance Sheet	Location of Offsetting	Offsetting
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Interest Rate Swap		Location	Fair Value	Balance	Amount
				(In thousands)	
Liability					
Cash flow hedge debt	\$155 million LIBOR based	Other long-term liabilities	\$ 11,825	Accumulated other comprehensive loss	\$ 11,825

In May 2010, we repaid \$16 million of our Credit Agreement debt and also settled a corresponding portion of our interest rate swap agreement having a notional amount of \$16 million for \$1.1 million. Upon payment, we reduced our swap liability and reclassified a \$1.1 million charge from accumulated other comprehensive loss to interest expense, representing the application of hedge accounting prior to settlement.

- 15 -

Table of Contents

In the first quarter of 2010, we settled two interest rate swaps. We had an interest rate swap contract that effectively converted interest expense associated with \$60 million of our 6.25% Senior Notes from fixed to variable rate debt (Variable Rate Swap). We had an additional interest rate swap contract that effectively unwound the effects of the Variable Rate Swap, converting \$60 million of the previously hedged long-term debt back to fixed rate debt (Fixed Rate Swap), effectively fixing interest at a 4.75% rate. Upon settlement of the Variable Rate and Fixed Rate Swaps, we received \$1.9 million and paid \$3.6 million, respectively.

For the nine months ended September 30, 2010 and 2009, we recognized \$1.5 million and \$0.3 million in non-cash charges to interest expense as a result of fair value adjustments to our interest rate swaps.

We have a deferred hedge premium that relates to the application of hedge accounting to the Variable Rate Swap prior to its hedge dedesignation in 2008. This deferred hedge premium having a balance of \$1.5 million at September 30, 2010, is being amortized as a reduction to interest expense over the remaining term of the 6.25% Senior Notes.

Interest Expense and Other Debt Information

Interest expense consists of the following components:

	September 30, 2010	September 30, 2009
	(In thousands)	
Interest on outstanding debt:		
Credit Agreement, net of interest on interest rate swap	\$ 6,908	\$ 7,745
6.25% Senior Notes, net of interest on interest rate swaps	8,514	8,320
8.25% Senior Notes	6,940	
Partial settlement of interest rate swap cash flow hedge	1,076	
Net fair value adjustments to interest rate swaps	1,464	300
Net amortization of discount and deferred debt issuance costs	710	529
Commitment fees	286	202
 Total interest incurred	 25,898	 17,096
 Less capitalized interest	 388	 871
 Net interest expense	 \$ 25,510	 \$ 16,225
 Cash paid for interest ⁽¹⁾	 \$ 29,515	 \$ 18,307

(1) Net of cash received under our interest rate swap agreements of \$1.9 million for the nine months ended September 30, 2010 and

\$3.8 million for
the nine months
ended
September 30,
2009.

Note 9: Significant Customers

All revenues are domestic revenues, of which 95 percent are currently generated from our two largest customers: Holly and Alon. The major part of our revenues is derived from activities conducted in the southwest United States.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Holly	80%	70%	81%	66%
Alon	15%	26%	14%	29%

- 16 -

Table of Contents

Note 10: Related Party Transactions

Holly and Alon Agreements

We serve Holly's refineries in New Mexico, Utah and Oklahoma under the following long-term pipeline and terminal, tankage and throughput agreements:

Holly PTA (pipelines and terminals throughput agreement expiring in 2019 that relates to assets contributed to us by Holly upon our initial public offering in 2004);

Holly IPA (intermediate pipelines throughput agreement expiring in 2024 that relates to assets acquired from Holly in 2005 and 2009);

Holly CPTA (crude pipelines and tankage throughput agreement expiring in 2023 that relates to assets acquired from Holly in 2008);

Holly PTTA (pipeline, tankage and loading rack throughput agreement expiring in 2024 that relates to the Tulsa east facilities acquired from Sinclair in 2009 and from Holly in March 2010);

Holly RPA (pipeline throughput agreement expiring in 2024 that relates to the Roadrunner Pipeline acquired from Holly in 2009);

Holly ETA (equipment and throughput agreement expiring in 2024 that relates to the Tulsa west facilities acquired from Holly in 2009);

Holly NPA (natural gas pipeline throughput agreement expiring in 2024); and

Holly ATA (asphalt loading rack throughput agreement expiring in 2025 that relates to the Lovington facility acquired from Holly in March 2010).

Under these agreements, Holly agreed to transport, store and throughput volumes of refined product and crude oil on our pipelines and terminal, tankage and loading rack facilities that result in minimum annual payments to us. These minimum annual payments or revenues will be adjusted each year at a percentage change based upon the change in the Producer Price Index (PPI) but will not decrease as a result of a decrease in the PPI. Under these agreements, the agreed upon tariff rates are adjusted each year on July 1 at a rate based upon the percentage change in the PPI or the Federal Energy Regulatory Commission (FERC) index, but with the exception of the Holly IPA, generally will not decrease as a result of a decrease in the PPI or FERC index. The FERC index is the change in the PPI plus a FERC adjustment factor that is reviewed periodically. Following the July 1, 2010 PPI adjustment, which was insignificant, these agreements with Holly will result in minimum annualized payments to us of \$133 million.

We also have a pipelines and terminals agreement with Alon expiring in 2020 under which Alon has agreed to transport on our pipelines and throughput through our terminals volumes of refined products that result in a minimum level of annual revenue. The agreed upon tariff rates are increased or decreased annually at a rate equal to the percentage change in PPI, but not below the initial tariff rate. Following the March 1, 2010 PPI adjustment, Alon's minimum annualized commitment to us is \$22.7 million.

If Holly or Alon fails to meet their minimum volume commitments under the agreements in any quarter, it will be required to pay us in cash the amount of any shortfall by the last day of the month following the end of the quarter. A shortfall payment under the Holly PTA, Holly IPA and Alon PTA may be applied as a credit in the following four quarters after minimum obligations are met.

We entered into an omnibus agreement with Holly in 2004 that Holly and we have amended and restated several times in connection with our past acquisitions from Holly with the last amendment and restatement occurring on March 31, 2010 (the Omnibus Agreement). Under certain provisions of the Omnibus Agreement, we pay Holly an annual administrative fee, currently \$2.3 million, for the provision by Holly or its affiliates of various general and administrative services to us. This fee does not include the salaries of pipeline and terminal personnel or the cost of their employee benefits, which are separately charged to us by Holly. Also, we reimburse Holly and its affiliates for direct expenses they incur on our behalf.

Table of Contents

Related party transactions with Holly are as follows:

Revenues received from Holly were \$37.3 million and \$28.4 million for the three months ended September 30, 2010 and 2009, respectively, and \$108 million and \$71.7 million for the nine months ended September 30, 2010 and 2009, respectively.

Holly charged general and administrative services under the Omnibus Agreement of \$0.6 million for the three months ended September 30, 2010 and 2009 and \$1.7 million for the nine months ended September 30, 2010 and 2009.

We reimbursed Holly for costs of employees supporting our operations of \$4.8 million and \$4.2 million for the three months ended September 30, 2010 and 2009, respectively, and \$13.6 million and \$12.8 million for the nine months ended September 30, 2010 and 2009, respectively.

We paid Holly a \$2.5 million finder's fee in connection the acquisition of our 25% joint venture interest in the SLC Pipeline in the first quarter of 2009.

We distributed \$9.1 million and \$7.6 million for the three months ended September 30, 2010 and 2009, respectively, to Holly as regular distributions on its common units, subordinated units and general partner interest, including general partner incentive distributions. We distributed \$26.5 million and \$21.6 million during the nine months ended September 30, 2010 and 2009, respectively.

Accounts receivable from Holly were \$17.6 million and \$14.1 million at September 30, 2010 and December 31, 2009, respectively.

Accounts payable to Holly were \$2.8 million and \$2.4 million at September 30, 2010 and December 31, 2009, respectively.

Revenues for the three and the nine months ended September 30, 2010 include \$0.6 million and \$2.9 million of shortfalls billed under the Holly IPA in 2009 as Holly did not exceed its minimum volume commitment in any of the subsequent four quarters. Deferred revenue in the consolidated balance sheets at September 30, 2010 and December 31, 2009, includes \$3.4 million and \$3.6 million, respectively, relating to the Holly IPA. It is possible that Holly may not exceed its minimum obligations under the Holly IPA to allow Holly to receive credit for any of the \$3.4 million deferred at September 30, 2010.

We acquired the Tulsa east and Lovington storage assets, Roadrunner and Beeson Pipelines, Tulsa loading racks and a 16-inch intermediate pipeline from Holly in March 2010, December 2009, August 2009 and June 2009, respectively. See Note 3 for a description of these transactions.

Alon became a related party when it acquired all of our Class B subordinated units in connection with our acquisition of assets from them in February 2005. In May 2010, all of the conditions necessary to end the subordination period for the 937,500 Class B subordinated units originally issued to Alon were met and the units were converted into our common units on a one-for-one basis.

Related party transactions with Alon are as follows:

Revenues received from Alon were \$5.4 million and \$8.8 million for the three months ended September 30, 2010 and 2009, respectively, and \$13.8 million and \$25.8 million for the nine months ended September 30, 2010 and 2009, respectively under the Alon PTA. Additionally, revenues received under a pipeline capacity lease agreement with Alon were \$1.7 million and \$1.6 million for the three months ended September 30, 2010 and 2009, respectively, and \$4.9 million and \$5 million for the nine months ended September 30, 2010 and 2009, respectively.

Accounts receivable trade include receivable balances from Alon of \$3.6 million at September 30, 2010 and \$4 million at December 31, 2009.

Table of Contents

Revenues for the three and the nine months ended September 30, 2010 include \$1.1 million and \$2.9 million, respectively, of shortfalls billed under the Alon PTA in 2010, as Alon did not exceed its minimum revenue obligation in any of the subsequent four quarters. Deferred revenue in the consolidated balance sheets at September 30, 2010 and December 31, 2009 includes \$8.3 million and \$4.8 million, respectively, relating to the Alon PTA. It is possible that Alon may not exceed its minimum obligations under the Alon PTA to allow Alon to receive credit for any of the \$8.3 million deferred at September 30, 2010.

Note 11: Partners Equity

Holly currently holds 7,290,000 of our common units and the 2% general partner interest, which together constitutes a 34% ownership interest in us.

Issuances of units

We issued 1,373,609 of our common units having a value of \$53.5 million to Sinclair as partial consideration of our total \$79.2 million purchase of Sinclair's Tulsa logistics assets in December 2009.

We issued in a public offering 2,185,000 of our common units priced at \$35.78 per unit in November 2009. Aggregate net proceeds of \$74.9 million were used to fund the cash portion of our December 2009 asset acquisitions, to repay outstanding borrowings under the Credit Agreement and for general partnership purposes.

Additionally, we issued in a public offering 2,192,400 of our common units priced at \$27.80 per unit in May 2009. Net proceeds of \$58.4 million were used to repay outstanding borrowings under the Credit Agreement and for general partnership purposes.

We received aggregate capital contributions of \$3.8 million from our general partner to maintain its 2% general partner interest concurrent with the 2009 common unit issuances described above.

Under our registration statement filed with the SEC using a "shelf" registration process, we currently have the ability to raise \$860 million through security offerings, through one or more prospectus supplements that would describe, among other things, the specific amounts, prices and terms of any securities offered and how the proceeds would be used. Any proceeds from the sale of securities would be used for general business purposes, which may include, among other things, funding acquisitions of assets or businesses, working capital, capital expenditures, investments in subsidiaries, the retirement of existing debt and/or the repurchase of common units or other securities.

Allocations of Net Income

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

The following table presents the allocation of the general partner interest in net income:

	Three Months Ended September 30, 2010		Nine Months Ended September 30, 2010	
	2009		2009	
	(In thousands)			
General partner interest in net income	\$ 271	\$ 300	\$ 659	\$ 691
General partner incentive distribution	2,901	1,722	8,068	4,472
Total general partner interest in net income attributable to HEP	\$ 3,172	\$ 2,022	\$ 8,727	\$ 5,163

Table of Contents***Cash Distributions***

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

On October 26, 2010, we announced our cash distribution for the third quarter of 2010 of \$0.835 per unit. The distribution is payable on all common, subordinated, and general partner units and will be paid November 12, 2010 to all unitholders of record on November 5, 2010.

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

	Three Months Ended September 30, 20102009		Nine Months Ended September 30, 20102009	
	(In thousands, except per unit data)			
General partner interest	\$ 436	\$ 336	\$ 1,280	\$ 947
General partner incentive distribution	2,901	1,722	8,068	4,472
Total general partner distribution	3,337	2,058	9,348	5,419
Limited partner distribution	18,435	14,723	54,566	41,938
Total regular quarterly cash distribution	\$ 21,772	\$ 16,781	\$ 63,914	\$ 47,357
Cash distribution per unit applicable to limited partners	\$ 0.835	\$ 0.795	\$ 2.475	\$ 2.355

As a master limited partnership, we distribute our available cash, which has historically exceeded our net income because depreciation and amortization expense represents a non-cash charge against income. The result is a decline in our equity since our regular quarterly distributions have exceeded our quarterly net income. Additionally, if the assets contributed and acquired from Holly while under common control of Holly had been acquired from third parties, our acquisition cost in excess of Holly's basis in the transferred assets of \$217.9 million would have been recorded in our financial statements as increases to our properties and equipment and intangible assets instead of decreases to partners' equity.

Comprehensive Income (Loss)

We have other comprehensive income (loss) resulting from fair value adjustments to our cash flow hedge. Our comprehensive income is as follows:

	Three Months Ended September 30, 2010 2009		Nine Months Ended September 30, 2010 2009	
	(In thousands)			
Net income	\$ 16,259	\$ 16,808	\$ 40,396	\$ 39,561
Other comprehensive income (loss):				
Change in fair value of cash flow hedge	(703)	(1,482)	(3,760)	2,786
Reclassification adjustment to net income on partial settlement of cash flow hedge			1,076	

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Other comprehensive income (loss)	(703)	(1,482)	(2,684)	2,786
Comprehensive income	15,556	15,326	37,712	42,347
Less noncontrolling interest in comprehensive income		269		1,191
Comprehensive income attributable to HEP unitholders	\$ 15,556	\$ 15,057	\$ 37,712	\$ 41,156

- 20 -

Table of Contents

Note 12: Supplemental Guarantor/Non-Guarantor Financial Information

Obligations of Holly Energy Partners, L.P. (Parent) under the 6.25% Senior Notes and 8.25% Senior Notes have been jointly and severally guaranteed by each of its direct and indirect wholly-owned subsidiaries (Guarantor Subsidiaries). These guarantees are full and unconditional.

We sold our 70% interest in Rio Grande on December 1, 2009; therefore, Rio Grande is no longer a subsidiary of HEP. Rio Grande (Non-Guarantor) was the only subsidiary that did not guarantee these obligations. Amounts attributable to Rio Grande prior to our sale are presented in discontinued operations.

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

- 21 -

Table of Contents**Condensed Consolidating Balance Sheet**

September 30, 2010	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
			(In thousands)	
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 2	\$ 704	\$	\$ 706
Accounts receivable		21,319		21,319
Intercompany accounts receivable (payable)	(73,158)	73,158		
Prepaid and other current assets	368	753		1,121
Total current assets	(72,788)	95,934		23,146
Properties and equipment, net		424,806		424,806
Investment in subsidiaries	517,300		(517,300)	
Transportation agreements, net		110,226		110,226
Goodwill		49,109		49,109
Investment in SLC Pipeline		25,513		25,513
Other assets	1,314	470		1,784
Total assets	\$ 445,826	\$ 706,058	\$ (517,300)	\$ 634,584

LIABILITIES AND PARTNERS EQUITY

Current liabilities:				
Accounts payable	\$	\$ 5,786	\$	\$ 5,786
Accrued interest	1,514	18		1,532
Deferred revenue		11,681		11,681
Accrued property taxes		1,497		1,497
Other current liabilities	800	242		1,042
Credit agreement borrowings		157,000		157,000
Total current liabilities	2,314	176,224		178,538
Long-term debt	332,564			332,564
Other long-term liabilities		12,534		12,534
Partners equity	110,948	517,300	(517,300)	110,948
Total liabilities and partners equity	\$ 445,826	\$ 706,058	\$ (517,300)	\$ 634,584

Condensed Consolidating Balance Sheet

December 31, 2009	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
			(In thousands)	
ASSETS				
Current assets:				
Cash and cash equivalents	\$ 2	\$ 2,506	\$	\$ 2,508

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Accounts receivable		18,767		18,767
Intercompany accounts receivable (payable)	(76,855)	76,855		
Prepaid and other current assets	261	478		739
Current assets of discontinued operations		2,195		2,195
Total current assets	(76,592)	100,801		24,209
Properties and equipment, net		398,044		398,044
Investment in subsidiaries	458,381		(458,381)	
Transportation agreements, net		115,436		115,436
Goodwill		49,109		49,109
Investment in SLC Pipeline		25,919		25,919
Other assets	3,267	861		4,128
Total assets	\$ 385,056	\$ 690,170	\$ (458,381)	\$ 616,845

LIABILITIES AND PARTNERS EQUITY

Current liabilities:				
Accounts payable	\$	\$ 6,211	\$	\$ 6,211
Accrued interest	2,849	14		2,863
Deferred revenue		8,402		8,402
Accrued property taxes		1,072		1,072
Other current liabilities	961	296		1,257
Total current liabilities	3,810	15,995		19,805
Long-term debt	184,827	206,000		390,827
Other long-term liabilities	2,555	9,794		12,349
Partners equity	193,864	458,381	(458,381)	193,864
Total liabilities and partners equity	\$ 385,056	\$ 690,170	\$ (458,381)	\$ 616,845

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

Three months ended September 30, 2010	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
		(In thousands)		
Revenues:				
Affiliates	\$	\$ 37,312	\$	\$ 37,312
Third parties		9,237		9,237
		46,549		46,549
Operating costs and expenses:				
Operations		13,632		13,632
Depreciation and amortization		7,237		7,237
General and administrative	888	620		1,508
	888	21,489		22,377
Operating income (loss)	(888)	25,060		24,172
Equity in earnings of subsidiaries	23,285		(23,285)	
Equity in earnings of SLC Pipeline		570		570
Interest income (expense)	(6,138)	(2,278)		(8,416)
Other		9		9
	17,147	(1,699)	(23,285)	(7,837)
Income (loss) before income taxes	16,259	23,361	(23,285)	16,335
State income tax		(76)		(76)
Net income	\$ 16,259	\$ 23,285	\$ (23,285)	\$ 16,259

Condensed Consolidating Statement of Income

Three months ended September 30, 2009	Parent	Guarantor Subsidiaries	Non- Guarantor	Eliminations	Consolidated
		(In thousands)			
Revenues:					
Affiliates	\$	\$ 28,359	\$	\$	\$ 28,359
Third parties		12,446			12,446
		40,805			40,805
Operating costs and expenses:					
Operations		11,103			11,103
Depreciation and amortization		6,580			6,580
General and administrative	1,210	638			1,848

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	1,210	18,321		19,531
Operating income (loss)	(1,210)	22,484		21,274
Equity in earnings of subsidiaries	21,408	628	(22,036)	
Equity in earnings of SLC Pipeline		711		711
Interest income (expense)	(3,659)	(2,757)		(6,416)
Other				
	17,749	(1,418)	(22,036)	(5,705)
Income (loss) from continuing operations before income taxes	16,539	21,066	(22,036)	15,569
State income tax		(100)		(100)
Income from continuing operations	16,539	20,966	(22,036)	15,469
Income from discontinued operations		442	897	(269)
				1,070
Net income	\$ 16,539	\$ 21,408	\$ 897	\$ (22,305)
				\$ 16,539

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

Nine months ended September 30, 2010	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
			(In thousands)	
Revenues:				
Affiliates	\$	\$ 107,988	\$	\$ 107,988
Third parties		24,740		24,740
		132,728		132,728
Operating costs and expenses:				
Operations		40,187		40,187
Depreciation and amortization		22,038		22,038
General and administrative	3,970	2,014		5,984
	3,970	64,239		68,209
Operating income (loss)	(3,970)	68,489		64,519
Equity in earnings of subsidiaries	61,603		(61,603)	
Equity in earnings of SLC Pipeline		1,595		1,595
Interest income (expense)	(17,237)	(8,267)		(25,504)
Other		2		2
	44,366	(6,670)	(61,603)	(23,907)
Income (loss) before income taxes	40,396	61,819	(61,603)	40,612
State income tax		(216)		(216)
Net income	\$ 40,396	\$ 61,603	\$ (61,603)	\$ 40,396

Condensed Consolidating Statement of Income

Nine months ended September 30, 2009	Parent	Guarantor Subsidiaries	Non- Guarantor	Eliminations	Consolidated
				(In thousands)	
Revenues:					
Affiliates	\$	\$ 71,746	\$	\$	\$ 71,746
Third parties		36,390			36,390
		108,136			108,136
Operating costs and expenses:					
Operations		32,076			32,076
Depreciation and amortization		19,209			19,209
General and administrative	3,195	1,784			4,979

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	3,195	53,069		56,264
Operating income (loss)	(3,195)	55,067		51,872
Equity in earnings of subsidiaries	50,026	2,780	(52,806)	
Equity in earnings of SLC Pipeline		1,309		1,309
SLC Pipeline acquisition costs		(2,500)		(2,500)
Interest income (expense)	(8,461)	(7,754)		(16,215)
Other		65		65
	41,565	(6,100)	(52,806)	(17,341)
Income (loss) from continuing operations before income taxes	38,370	48,967	(52,806)	34,531
State income tax		(266)		(266)
Income from continuing operations	38,370	48,701	(52,806)	34,265
Income from discontinued operations		1,325	3,971	(1,191)
				4,105
Net income	\$ 38,370	\$ 50,026	\$ 3,971	\$ (53,997)
				\$ 38,370

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

Nine months ended September 30, 2010	Parent	Guarantor Subsidiaries	Eliminations	Consolidated
		(In thousands)		
Cash flows from operating activities	\$ (82,123)	\$ 148,252	\$	\$ 66,129
Cash flows from investing activities				
Additions to properties and equipment		(8,054)		(8,054)
Acquisition of assets from Holly Corporation		(35,526)		(35,526)
		(43,580)		(43,580)
Cash flows from financing activities				
Net repayments under credit agreement		(49,000)		(49,000)
Net proceeds from issuance of senior notes	147,540			147,540
Distributions to HEP unitholders	(62,648)			(62,648)
Purchase price in excess of transferred basis in assets acquired from Holly Corporation		(57,474)		(57,474)
Purchase of units for restricted grants	(2,276)			(2,276)
Deferred financing costs	(493)			(493)
	82,123	(106,474)		(24,351)
Cash and cash equivalents				
Increase (decrease) for the period		(1,802)		(1,802)
Beginning of period	2	2,506		2,508
End of period	\$ 2	\$ 704	\$	\$ 706

Condensed Consolidating Statement of Cash Flows

Nine months ended September 30, 2009	Parent	Guarantor Subsidiaries	Non- Guarantor	Eliminations	Consolidated
			(In thousands)		
Cash flows from operating activities	\$ (14,887)	\$ 56,819	\$ 4,256	\$ (1,400)	\$ 44,788
Cash flows from investing activities					
Additions to properties and equipment		(27,406)	(72)		(27,478)
Acquisition of assets from Holly Corporation		(46,000)			(46,000)
Investment in SLC Pipeline		(25,500)			(25,500)
		(98,906)	(72)		(98,978)

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Cash flows from financing activities					
Net borrowings under credit agreement		45,000			45,000
Proceeds from issuance of common units	58,355				58,355
Contribution from general partner	1,191				1,191
Distributions to HEP unitholders	(44,393)		(2,000)	2,000	(44,393)
Distributions to noncontrolling interest				(600)	(600)
Purchase price in excess of transferred basis in assets acquired from Holly Corporation		(5,700)			(5,700)
Purchase of units for restricted grants		(616)			(616)
Cost of issuing common units	(266)				(266)
	14,887	38,684	(2,000)	1,400	52,971
Cash and cash equivalents					
Increase (decrease) for the period		(3,403)	2,184		(1,219)
Beginning of period	2	3,706	1,561		5,269
End of period	\$ 2	\$ 303	\$ 3,745	\$	\$ 4,050

- 25 -

Table of Contents

HOLLY ENERGY PARTNERS, L.P.

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

This Item 2, including but not limited to the sections on Results of Operations and Liquidity and Capital Resources, contains forward-looking statements. See Forward-Looking Statements at the beginning of Part I on this Quarterly Report on Form 10-Q. In this document, the words we, our, ours and us refer to HEP and its consolidated subsidiaries or to HEP or an individual subsidiary and not to any other person.

OVERVIEW

Holly Energy Partners, L.P. is a Delaware limited partnership. We own and operate petroleum product and crude oil pipeline and terminal, tankage and loading rack facilities that support Holly Corporation's (Holly) refining and marketing operations in west Texas, New Mexico, Utah, Oklahoma, Idaho and Arizona. Holly currently owns a 34% interest in us including the 2% general partner interest. We also own and operate refined product pipelines and terminals, located primarily in Texas, that service Alon's (Alon) refinery in Big Spring, Texas. Additionally, we own a 25% joint venture interest in a 95-mile intrastate crude oil pipeline system (the SLC Pipeline) that serves refineries in the Salt Lake City area.

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

2010 Acquisitions

Tulsa East / Lovington Storage Asset Transaction

On March 31, 2010, we acquired from Holly certain storage assets for \$93 million, consisting of hydrocarbon storage tanks having approximately 2 million barrels of storage capacity, a rail loading rack and a truck unloading rack located at Holly's Tulsa refinery east facility and an asphalt loading rack facility located at Holly's Navajo refinery facility in Lovington, New Mexico.

2009 Acquisitions

Sinclair Logistics and Storage Assets Transaction

On December 1, 2009, we acquired from an affiliate of Sinclair Oil Company (Sinclair) storage tanks having approximately 1.4 million barrels of storage capacity and loading racks at its refinery located in Tulsa, Oklahoma for \$79.2 million.

Roadrunner / Beeson Pipelines Transaction

Also on December 1, 2009, we acquired from Holly two newly constructed pipelines for \$46.5 million, consisting of a 65-mile, 16-inch crude oil pipeline (the Roadrunner Pipeline) that connects the Navajo refinery Lovington facility to a terminus of Centurion Pipeline L.P.'s pipeline extending between west Texas and Cushing, Oklahoma and a 37-mile, 8-inch crude oil pipeline that connects our New Mexico crude oil gathering system to the Navajo refinery Lovington facility (the Beeson Pipeline).

Tulsa Loading Racks Transaction

On August 1, 2009, we acquired from Holly certain truck and rail loading/unloading facilities located at Holly's Tulsa refinery west facility for \$17.5 million. The racks load refined products and lube oils produced at the Tulsa refinery onto rail cars and/or tanker trucks.

Table of Contents

Lovington-Artesia Pipeline Transaction

On June 1, 2009, we acquired from Holly a newly constructed 16-inch intermediate pipeline for \$34.2 million that runs 65 miles from the Navajo refinery's crude oil distillation and vacuum facilities in Lovington, New Mexico to its petroleum refinery located in Artesia, New Mexico.

SLC Pipeline Joint Venture Interest

On March 1, 2009, we acquired a 25% joint venture interest in the SLC Pipeline, a new 95-mile intrastate pipeline system that we jointly own with Plains All American Pipeline, L.P. (Plains). The total cost of our investment in the SLC Pipeline was \$28 million, consisting of the capitalized \$25.5 million joint venture contribution and the \$2.5 million finder's fee paid to Holly that was expensed as acquisition costs.

Holly Capacity Expansion

Also in March 2009 Holly, our largest customer, completed a 15,000 barrels per stream day (bpsd) capacity expansion of its Navajo refinery increasing refining capacity to 100,000 bpsd, or by 18%.

Rio Grande Pipeline Sale

On December 1, 2009, we sold our 70% interest in the Rio Grande Pipeline Company (Rio Grande) to a subsidiary of Enterprise Products Partners LP for \$35 million. Accordingly, the results of operations of Rio Grande are presented in discontinued operations.

Agreements with Holly Corporation and Alon

We serve Holly's refineries in New Mexico, Utah and Oklahoma under the following long-term pipeline and terminal, tankage and throughput agreements:

Holly PTA (pipelines and terminals throughput agreement expiring in 2019 that relates to assets contributed to us by Holly upon our initial public offering in 2004);

Holly IPA (intermediate pipelines throughput agreement expiring in 2024 that relates to assets acquired from Holly in 2005 and 2009);

Holly CPTA (crude pipelines and tankage throughput agreement expiring in 2023 that relates to assets acquired from Holly in 2008);

Holly PTTA (pipeline, tankage and loading rack throughput agreement expiring in 2024 that relates to the Tulsa east facilities acquired from Sinclair in 2009 and from Holly in March 2010);

Holly RPA (pipeline throughput agreement expiring in 2024 that relates to the Roadrunner Pipeline acquired from Holly in 2009);

Holly ETA (equipment and throughput agreement expiring in 2024 that relates to the Tulsa west facilities acquired from Holly in 2009);

Holly NPA (natural gas pipeline throughput agreement expiring in 2024); and

Holly ATA (asphalt loading rack throughput agreement expiring in 2025 that relates to the Lovington facility acquired from Holly in March 2010).

Under these agreements, Holly agreed to transport, store and throughput volumes of refined product and crude oil on our pipelines and terminal, tankage and loading rack facilities that result in minimum annual payments to us. These minimum annual payments or revenues will be adjusted each year at a percentage change based upon the change in the Producer Price Index (PPI) but will not decrease as a result of a decrease in the PPI. Under these agreements, the agreed upon tariff rates are adjusted each year on July 1 at a rate based upon the percentage change in the PPI or Federal Energy Regulatory Commission (FERC) index, but with the exception of the Holly IPA, generally will not decrease as a result of a decrease in the PPI or FERC index. The FERC index is the change in the PPI plus a FERC adjustment factor that is reviewed periodically.

We also have a pipelines and terminals agreement with Alon expiring in 2020 under which Alon has agreed to transport on our pipelines and throughput through our terminals volumes of refined products that result in a minimum level of annual revenue. The agreed upon tariff rates are increased or decreased annually at a rate equal to the percentage change in PPI, but not below the initial tariff rate.

Table of Contents

At October 1, 2010, contractual minimums under our long-term service agreements are as follows:

Agreement	Minimum Annualized Commitment (In millions)	Year of Maturity	Contract Type
Holly PTA	\$ 43.7	2019	Minimum revenue commitment
Holly IPA	20.7	2024	Minimum revenue commitment
Holly CPTA	28.4	2023	Minimum revenue commitment
Holly PTTA	27.2	2024	Minimum revenue commitment
Holly RPA	9.2	2024	Minimum revenue commitment
Holly ETA	2.7	2024	Minimum revenue commitment
Holly ATA	0.5	2025	Minimum revenue commitment
Holly NPA	0.6	2024	Minimum revenue commitment
Alon PTA	22.7	2020	Minimum volume commitment
Alon capacity lease	6.4	Various	Capacity lease
 Total	 \$ 162.1		

A significant reduction in revenues under these agreements would have a material adverse effect on our results of operations.

We entered into an omnibus agreement with Holly in 2004 that Holly and we have amended and restated several times in connection with our past acquisitions from Holly with the last amendment and restatement occurring on March 31, 2010 (the Omnibus Agreement). Under certain provisions of the Omnibus Agreement, we pay Holly an annual administrative fee, currently \$2.3 million, for the provision by Holly or its affiliates of various general and administrative services to us. This fee does not include the salaries of pipeline and terminal personnel or the cost of their employee benefits, which are separately charged to us by Holly. Also, we reimburse Holly and its affiliates for direct expenses they incur on our behalf.

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

The following tables present income, distributable cash flow and volume information for the three and the nine months ended September 30, 2010 and 2009.

	Three Months Ended September 30, 2010 2009		Change from 2009
	(In thousands, except per unit data)		
Revenues			
Pipelines:			
Affiliates refined product pipelines	\$ 12,340	\$ 12,267	\$ 73
Affiliates intermediate pipelines	4,917	5,370	(453)
Affiliates crude pipelines	9,775	7,563	2,212
	27,032	25,200	1,832
Third parties refined product pipelines	7,277	10,552	(3,275)
	34,309	35,752	(1,443)
Terminals and loading racks:			
Affiliates	10,281	3,159	7,122
Third parties	1,959	1,894	65
	12,240	5,053	7,187
Total revenues	46,549	40,805	5,744
Operating costs and expenses			
Operations	13,632	11,103	2,529
Depreciation and amortization	7,237	6,580	657
General and administrative	1,508	1,848	(340)
	22,377	19,531	2,846
Operating income	24,172	21,274	2,898
Equity in earnings of SLC Pipeline	570	711	(141)
Interest income	1	2	(1)
Interest expense, including amortization	(8,417)	(6,418)	(1,999)
Other	9		9
	(7,837)	(5,705)	(2,132)
Income from continuing operations before income taxes	16,335	15,569	766
State income tax	(76)	(100)	24

Income from continuing operations	16,259	15,469	790
Income from discontinued operations, net of noncontrolling interest of \$269 ⁽¹⁾		1,070	(1,070)
Net income	16,259	16,539	(280)
Less general partner interest in net income, including incentive distributions ⁽²⁾	3,172	2,022	1,150
Limited partners interest in net income	\$ 13,087	\$ 14,517	\$ (1,430)
Limited partners earnings per unit basic and diluted ⁽³⁾			
Income from continuing operations	\$ 0.59	\$ 0.73	\$ (0.14)
Income from discontinued operations		0.05	(0.05)
Net income	\$ 0.59	\$ 0.78	\$ (0.19)
Weighted average limited partners units outstanding	22,079	18,520	3,559
EBITDA ⁽³⁾	\$ 31,988	\$ 29,888	\$ 2,100
Distributable cash flow ⁽⁴⁾	\$ 23,969	\$ 20,678	\$ 3,291
Volumes from continuing operations (bpd) ⁽¹⁾			
Pipelines:			
Affiliates refined product pipelines	93,194	98,987	(5,793)
Affiliates intermediate pipelines	83,227	88,053	(4,826)
Affiliates crude pipelines	143,617	143,902	(285)
	320,038	330,942	(10,904)
Third parties refined product pipelines	41,967	43,858	(1,891)
	362,005	374,800	(12,795)
Terminals and loading racks:			
Affiliates	183,312	122,413	60,899
Third parties	43,633	44,459	(826)
	226,945	166,872	60,073
Total for pipelines and terminal assets (bpd)	588,950	541,672	47,278

Table of Contents

	Nine Months Ended September 30, 2010 2009		Change from 2009
	(In thousands, except per unit data)		
Revenues			
Pipelines:			
Affiliates refined product pipelines	\$ 35,887	\$ 31,186	\$ 4,701
Affiliates intermediate pipelines	15,673	11,438	4,235
Affiliates crude pipelines	28,907	21,215	7,692
	80,467	63,839	16,628
Third parties refined product pipelines	19,136	31,125	(11,989)
	99,603	94,964	4,639
Terminals and loading racks:			
Affiliates	27,522	7,907	19,615
Third parties	5,603	5,265	338
	33,125	13,172	19,953
Total revenues	132,728	108,136	24,592
Operating costs and expenses			
Operations	40,187	32,076	8,111
Depreciation and amortization	22,038	19,209	2,829
General and administrative	5,984	4,979	1,005
	68,209	56,264	11,945
Operating income	64,519	51,872	12,647
Equity in earnings of SLC Pipeline	1,595	1,309	286
SLC Pipeline acquisition costs		(2,500)	2,500
Interest income	6	10	(4)
Interest expense, including amortization	(25,510)	(16,225)	(9,285)
Other	2	65	(63)
	(23,907)	(17,341)	(6,566)
Income from continuing operations before income taxes	40,612	34,531	6,081
State income tax	(216)	(266)	50
Income from continuing operations	40,396	34,265	6,131

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Income from discontinued operations, net of noncontrolling interest of \$1,191 ⁽¹⁾		4,105	(4,105)
Net income	40,396	38,370	2,026
Less general partner interest in net income, including incentive distributions ⁽²⁾	8,727	5,163	3,564
Limited partners interest in net income	\$ 31,669	\$ 33,207	\$ (1,538)
Limited partners earnings per unit basic and diluted⁽²⁾			
Income from continuing operations	\$ 1.43	\$ 1.66	\$ (0.23)
Income from discontinued operations		0.23	(0.23)
Net income	\$ 1.43	\$ 1.89	\$ (0.46)
Weighted average limited partners units outstanding	22,079	17,546	4,533
EBITDA ⁽³⁾	\$ 88,154	\$ 74,831	\$ 13,323
Distributable cash flow ⁽⁴⁾	\$ 66,800	\$ 51,677	\$ 15,123
Volumes from continuing operations (bpd) ⁽¹⁾			
Pipelines:			
Affiliates refined product pipelines	95,013	85,489	9,524
Affiliates intermediate pipelines	82,844	64,494	18,350
Affiliates crude pipelines	139,955	136,315	3,640
	317,812	286,298	31,514
Third parties refined product pipelines	35,923	45,647	(9,724)
	353,735	331,945	21,790
Terminals and loading racks:			
Affiliates	177,946	106,969	70,977
Third parties	38,825	42,873	(4,048)
	216,771	149,842	66,929
Total for pipelines and terminal assets (bpd)	570,506	481,787	88,719

Table of Contents

- (1) On December 1, 2009, we sold our 70% interest in Rio Grande. Results of operations of Rio Grande are presented in discontinued operations. Pipeline volume information excludes volumes attributable to Rio Grande.
- (2) Net income is allocated between limited partners and the general partner interest in accordance with the provisions of the partnership agreement. Net income allocated to the general partner includes incentive distributions declared subsequent to quarter end. Net income attributable to the limited partners is divided by the weighted average limited partner units outstanding in computing the limited partners per unit interest in net income.

- (3) EBITDA is calculated as net income plus (i) interest expense, net of interest income, (ii) state income tax and (iii) depreciation and amortization. EBITDA is not a calculation based upon GAAP. However, the amounts included in the EBITDA calculation are derived from amounts included in our consolidated financial statements, with the exception of EBITDA from discontinued operations. EBITDA should not be considered as an alternative to net income or operating income, as an indication of our operating performance or as an alternative to operating cash flow as a measure of liquidity. EBITDA is not necessarily comparable to similarly titled measures of other companies. EBITDA is

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

Set forth below is our calculation of EBITDA.

	Three Months Ended		Nine Months Ended	
	September 30,		September 30,	
	2010	2009	2010	2009
	(In thousands)			
Income from continuing operations	\$ 16,259	\$ 15,469	\$ 40,396	\$ 34,265
Add (subtract):				
Interest expense	8,135	5,314	22,230	15,396
Amortization of discount and deferred debt issuance costs	282	176	740	529
Increase in interest expense change in fair value of interest rate swaps and swap settlement costs		928	2,540	300
Interest income	(1)	(2)	(6)	(10)
State income tax	76	100	216	266
Depreciation and amortization	7,237	6,580	22,038	19,209
EBITDA from discontinued operations		1,323		4,876
EBITDA	\$ 31,988	\$ 29,888	\$ 88,154	\$ 74,831

(4) Distributable
cash flow is not
a calculation
based upon
GAAP.
However, the
amounts
included in the
calculation are

derived from
amounts
separately
presented in our
consolidated
financial
statements, with
the exception of
equity in excess
cash flows over
earnings of SLC
Pipeline,
maintenance
capital
expenditures
and distributable
cash flow from
discontinued
operations.
Distributable
cash flow
should not be
considered in
isolation or as
an alternative to
net income or
operating
income as an
indication of our
operating
performance or
as an alternative
to operating
cash flow as a
measure of
liquidity.
Distributable
cash flow is not
necessarily
comparable to
similarly titled
measures of
other
companies.
Distributable
cash flow is
presented here
because it is a
widely accepted
financial

indicator used
by investors to
compare
partnership
performance. It
also is used by
management for
internal analysis
and for our
performance
units. We
believe that this
measure
provides
investors an
enhanced
perspective of
the operating
performance of
our assets and
the cash our
business is
generating.

Table of Contents

Set forth below is our calculation of distributable cash flow.

	Three Months Ended September 30, 2010		September 30, 2009		Nine Months Ended September 30, 2010		September 30, 2009	
	(In thousands)							
Income from continuing operations	\$	16,259	\$	15,469	\$	40,396	\$	34,265
Add (subtract):								
Depreciation and amortization		7,237		6,580		22,038		19,209
Amortization of discount and deferred debt issuance costs		282		176		740		529
Increase in interest expense change in fair value of interest rate swaps and swap settlement costs				928		2,540		300
Equity in excess cash flows over earnings of SLC Pipeline		173		167		525		387
Increase (decrease) in deferred revenue		758		(3,407)		3,279		(8,076)
SLC Pipeline acquisition costs*								2,500
Maintenance capital expenditures**		(740)		(545)		(2,718)		(2,262)
Distributable cash flow from discontinued operations				1,310				4,825
Distributable cash flow	\$	23,969	\$	20,678	\$	66,800	\$	51,677

* We expensed the \$2.5 million finder's fee associated with our joint venture agreement with Plains that closed in March 2009. These costs directly relate to our interest in the new joint venture pipeline and are similar to expansion capital expenditures; accordingly, we have added back these costs to arrive at

distributable
cash flow.

** Maintenance
capital
expenditures are
capital
expenditures
made to replace
partially or fully
depreciated
assets in order
to maintain the
existing
operating
capacity of our
assets and to
extend their
useful lives.
Maintenance
capital
expenditures
include
expenditures
required to
maintain
equipment
reliability,
tankage and
pipeline
integrity, safety
and to address
environmental
regulations.

September
30, **December 31,**
2010 **2009**
(In thousands)

Balance Sheet Data

Cash and cash equivalents	\$ 706	\$ 2,508
Working capital ⁽⁵⁾	\$ (155,392)	\$ 4,404
Total assets	\$ 634,584	\$ 616,845
Long-term debt ⁽⁶⁾	\$ 332,564	\$ 390,827
Partners' equity ⁽⁷⁾	\$ 110,948	\$ 193,864

(5) Our credit
agreement
expires in

August 2011;
therefore,
working capital
at September
30, 2010 reflects
\$157 million of
credit agreement
borrowings that
are currently
classified as
current
liabilities. We
intend to renew
the credit
agreement prior
to expiration
and to continue
to finance
outstanding
credit agreement
borrowings.
Upon renewal,
outstanding
borrowings not
designated for
working capital
purposes will be
reclassified as
long-term debt.
Excluding the
\$157 million
credit agreement
borrowings,
working capital
was \$1.6 million
at
September 30,
2010.

- (6) Includes
\$206 million of
credit agreement
advances at
December 31,
2009.
- (7) As a master
limited
partnership, we
distribute our

available cash,
which
historically has
exceeded our
net income
because
depreciation and
amortization
expense
represents a
non-cash charge
against income.
The result is a
decline in
partners' equity
since our
regular quarterly
distributions
have exceeded
our quarterly net
income.
Additionally, if
the assets
contributed and
acquired from
Holly while
under common
control of Holly
had been
acquired from
third parties, our
acquisition cost
in excess of
Holly's basis in
the transferred
assets of
\$217.9 million
would have
been recorded in
our financial
statements as
increases to our
properties and
equipment and
intangible assets
instead of
decreases to
partners' equity.

Table of Contents

Results of Operations Three Months Ended September 30, 2010 Compared with Three Months Ended September 30, 2009

Summary

Income from continuing operations for the three months ended September 30, 2010 was \$16.3 million, a \$0.8 million increase compared to the three months ended September 30, 2009. This increase in overall earnings is due principally to earnings attributable to our December 2009 and March 2010 asset acquisitions, partially offset by a decrease in previously deferred revenue realized, decreased shipments and increased interest costs.

Revenues for the three months ended September 30, 2010 include the recognition of \$1.6 million of prior shortfalls billed to shippers in 2009 as they did not meet their minimum volume commitments in any of the subsequent four quarters. Revenues of \$2.4 million relating to deficiency payments associated with certain guaranteed shipping contracts were deferred during the three months ended September 30, 2010. Such deferred revenue will be recognized in earnings either as payment for shipments in excess of guaranteed levels or in 2011 when shipping rights expire unused after a twelve-month period.

Revenues

Total revenues from continuing operations for the three months ended September 30, 2010 were \$46.5 million, a \$5.7 million increase compared to the three months ended September 30, 2009. This is due principally to revenues attributable to our December 2009 and March 2010 asset acquisitions, partially offset by a \$3.4 million decrease in previously deferred revenue realized and a decrease in pipeline shipments. The small decrease in affiliate pipeline shipments reflects slightly lower run rates at Holly s Navajo refinery during the third quarter due to the impact of unscheduled downtime of certain operating units.

Revenues from our refined product pipelines were \$19.6 million, a decrease of \$3.2 million compared to the three months ended September 30, 2009. This decrease is due principally to a \$3.2 million decrease in previously deferred revenue realized. Volumes shipped on our refined product pipelines averaged 135.2 thousand barrels per day (mbpd) compared to 142.8 mbpd for the same period last year.

Revenues from our intermediate pipelines were \$4.9 million, a decrease of \$0.5 million compared to the three months ended September 30, 2009. This includes a \$0.2 million decrease in previously deferred revenue realized. Shipments on our intermediate product pipeline system decreased to an average of 83.2 mbpd compared to 88.1 mbpd for the same period last year.

Revenues from our crude pipelines were \$9.8 million, an increase of \$2.2 million compared to the three months ended September 30, 2009. This increase is due principally to \$2.3 million in revenues attributable to our Roadrunner Pipeline agreement entered into in December 2009. Volumes on our crude pipelines averaged 143.6 mbpd compared to 143.9 mbpd for the same period last year.

Revenues from terminal, tankage and loading rack fees were \$12.2 million, an increase of \$7.2 million compared to the three months ended September 30, 2009. This increase includes an increase of \$7.1 million in revenues attributable to volumes transferred and stored at our Tulsa storage and rack facilities. Refined products terminalled in our facilities increased to an average of 226.9 mbpd compared to 166.9 mbpd for the same period last year.

Operations Expense

Operations expense for the three months ended September 30, 2010 increased by \$2.5 million compared to the three months ended September 30, 2009. This increase was due principally to operating costs attributable to our December 2009 and March 2010 asset acquisitions, and higher maintenance and payroll expense.

Table of Contents

Depreciation and Amortization

Depreciation and amortization for the three months ended September 30, 2010 increased by \$0.7 million compared to the three months ended September 30, 2009. This was due to increased depreciation attributable to our December 2009 and March 2010 asset acquisitions and capital projects. Additionally, effective January 1, 2010, we revised the estimated useful lives of our terminal assets to 16 to 25 years resulting in a \$0.7 million reduction in depreciation expense for the three months ended September 30, 2010.

General and Administrative

General and administrative costs for the three months ended September 30, 2010 decreased by \$0.3 million compared to the three months ended September 30, 2009.

Equity in Earnings of SLC Pipeline

Our equity in earnings of the SLC Pipeline were \$0.6 million and \$0.7 million for the three months ended September 30, 2010 and 2009, respectively.

Interest Expense

Interest expense for the three months ended September 30, 2010 totaled \$8.4 million, an increase of \$2 million compared to the three months ended September 30, 2009. This increase reflects interest on our 8.25% senior notes. For the three months ended September 30, 2009, fair value adjustments to our interest rate swaps resulted in a \$0.9 million increase in interest expense. Excluding the effects of these fair value adjustments, our aggregate effective interest rate was 6.9% for the three months ended September 30, 2010 compared to 5.2% for 2009, reflecting interest on our 8.25% senior notes issued in March 2010.

State Income Tax

We recorded state income taxes of \$0.1 million for the three months ended September 30, 2010 and 2009, which are solely attributable to the Texas margin tax.

Discontinued Operations

We sold our interest in Rio Grande on December 1, 2009. Income from discontinued operations for the three months ended September 30, 2009 consists of earnings generated by Rio Grande of \$1.1 million for the third quarter of 2009 and is presented net of earnings attributable to noncontrolling interest holders of \$0.3 million.

Results of Operations Nine Months ended September 30, 2010 Compared with Nine Months ended September 30, 2009

Summary

Income from continuing operations for the nine months ended September 30, 2010 was \$40.4 million, a \$6.1 million increase compared to the nine months ended September 30, 2009. This increase in overall earnings is due principally to overall increased shipments on our pipeline systems and earnings attributable to our 2009 and March 2010 asset acquisitions. These factors were partially offset by increased operating costs and expenses, and interest expense.

Revenues for the nine months ended September 30, 2010 include the recognition of \$5.7 million of prior shortfalls billed to shippers in 2009 as they did not meet their minimum volume commitments in any of the subsequent four quarters. Revenues of \$9 million relating to deficiency payments associated with certain guaranteed shipping contracts were deferred during the nine months ended September 30, 2010. Such deferred revenue will be recognized in earnings either as payment for shipments in excess of guaranteed levels or in 2011 when shipping rights expire unused after a twelve-month period.

Table of Contents

Revenues

Total revenues from continuing operations for the nine months ended September 30, 2010 were \$132.7 million, a \$24.6 million increase compared to the nine months ended September 30, 2009. This increase is due principally to revenues attributable to our recent asset acquisitions and higher tariffs on affiliate shipments, partially offset by an \$8.1 million decrease in previously deferred revenue realized. On a year-to-date basis, overall pipeline shipments were up 7%, reflecting increased affiliate volumes attributable to Holly's first quarter of 2009 Navajo refinery expansion, including volumes shipped on our new 16-inch intermediate and Beeson pipelines, partially offset by a decrease in third-party shipments. Additionally, prior year affiliate shipments reflect lower volumes as a result of production downtime during a major maintenance turnaround of the Navajo refinery during the first quarter of 2009.

Revenues from our refined product pipelines were \$55 million, a decrease of \$7.3 million compared to the nine months ended September 30, 2009. This decrease is due principally to a \$9.1 million decrease in previously deferred revenue realized that was partially offset by higher tariffs on affiliate shipments. Volumes shipped on our refined product pipeline system averaged 130.9 mbpd compared to 131.1 mbpd for the same period last year reflecting a decrease in third-party shipments, offset by an increase in affiliate shipments.

Revenues from our intermediate pipelines were \$15.7 million, an increase of \$4.2 million compared to the nine months ended September 30, 2009. This increase includes a \$1 million increase in previously deferred revenue realized. Additionally, shipments on our intermediate product pipeline system increased to an average of 82.8 mbpd compared to 64.5 mbpd for the same period last year reflecting volumes shipped on our 16-inch intermediate pipeline acquired in June 2009.

Revenues from our crude pipelines were \$28.9 million, an increase of \$7.7 million compared to the nine months ended September 30, 2009. This increase is due principally to \$6.9 million in revenues attributable to our Roadrunner Pipeline agreement entered into in December 2009. Additionally, shipments on our crude pipeline system increased to an average of 140 mbpd during the nine months ended September 30, 2010 compared to 136.3 mbpd for the same period last year reflecting increased affiliate shipments.

Revenues from terminal, tankage and loading rack fees were \$33.1 million, an increase of \$20 million compared to the nine months ended September 30, 2009. This increase includes \$19 million in revenues attributable to volumes transferred and stored at our Tulsa storage and rack facilities acquired in 2009 and March 2010. Refined products terminalled in our facilities increased to an average of 216.8 mbpd compared to 149.8 mbpd for the same period last year.

Operations Expense

Operations expense for the nine months ended September 30, 2010 increased by \$8.1 million compared to the nine months ended September 30, 2009. This increase was due principally to costs attributable to overall higher throughput volumes, including those from our recent asset acquisitions, and higher maintenance and payroll costs.

Depreciation and Amortization

Depreciation and amortization for the nine months ended September 30, 2010 increased by \$2.8 million compared to the nine months ended September 30, 2009. This was due to increased depreciation attributable to our 2009 and March 2010 asset acquisitions and capital projects. Additionally, effective January 1, 2010, we revised the estimated useful lives of our terminal assets to 16 to 25 years resulting in a \$2.2 million reduction in depreciation expense for the nine months ended September 30, 2010.

Table of Contents

General and Administrative

General and administrative costs for the nine months ended September 30, 2010 increased by \$1 million compared to the nine months ended September 30, 2009, due principally to increased professional fees, including costs attributable to our March 2010 asset acquisitions.

Equity in Earnings of SLC Pipeline

The SLC Pipeline commenced pipeline operations effective March 2009. Our equity in earnings of the SLC Pipeline was \$1.6 million and \$1.3 million for the nine months ended September 30, 2010 and 2009, respectively.

SLC Pipeline Acquisition Costs

We incurred a \$2.5 million finder's fee in connection with the acquisition our SLC Pipeline joint venture interest in March 2009. As a result of accounting requirements, we were required to expense rather than capitalize these direct acquisition costs.

Interest Expense

Interest expense for the nine months ended September 30, 2010 totaled \$25.5 million, an increase of \$9.3 million compared to the nine months ended September 30, 2009. This increase reflects interest on our 8.25% senior notes and costs of \$1.1 million from a partial settlement of an interest rate swap. Fair value adjustments to our interest rate swaps resulted in a \$1.5 million non-cash charge to interest expense for the nine months ended September 30, 2010 compared to \$0.3 million for the nine months ended September 30, 2009. Excluding the effects of these fair value adjustments, our aggregate effective interest rate was 6.8% for the nine months ended September 30, 2010 compared to 5.2% for 2009 reflecting interest on our 8.25% senior notes issued in March 2010.

State Income Tax

We recorded state income taxes of \$0.2 million and \$0.3 million for the nine months ended September 30, 2010 and 2009, respectively, which are solely attributable to the Texas margin tax.

Discontinued Operations

We sold our interest in Rio Grande on December 1, 2009. Income from discontinued operations for the nine months ended September 30, 2009 consists of earnings generated by Rio Grande of \$4.1 million for the first nine months of 2009 and is presented net of earnings attributable to noncontrolling interest holders of \$1.2 million.

LIQUIDITY AND CAPITAL RESOURCES

Overview

We have a \$300 million senior secured revolving credit agreement expiring in August 2011 (the "Credit Agreement"). The Credit Agreement is available to fund capital expenditures, acquisitions, and working capital and for general partnership purposes. In addition, the Credit Agreement is available to fund letters of credit up to a \$50 million sub-limit and to fund distributions to unitholders up to a \$20 million sub-limit. During the nine months ended September 30, 2010, we received advances totaling \$52 million and repaid \$101 million, resulting in the net repayment of \$49 million in advances. As of September 30, 2010, we had \$157 million outstanding under the Credit Agreement that was used to finance acquisitions and capital projects. The Credit Agreement expires in August 2011, therefore, outstanding borrowings all of which were previously classified as long-term liabilities are currently classified as current liabilities. We intend to renew the Credit Agreement prior to expiration and to continue to finance outstanding Credit Agreement borrowings. Upon renewal, outstanding borrowings not designated for working capital purposes will be reclassified as long-term debt.

Table of Contents

In March 2010, we issued \$150 million in aggregate principal amount of 8.25% senior notes maturing March 15, 2018 (the "8.25% Senior Notes"). A portion of the \$147.5 million in net proceeds received was used to fund our \$93 million purchase of the Tulsa and Lovington storage assets from Holly on March 31, 2010. Additionally, we used a portion to repay \$42 million in outstanding Credit Agreement borrowings, with the remaining proceeds available for general partnership purposes, including working capital and capital expenditures. In addition, we have outstanding \$185 million in aggregate principal amount of 6.25% senior notes maturing March 1, 2015 (the "6.25% Senior Notes") that are registered with the SEC.

Under our registration statement filed with the SEC using a "shelf" registration process, we currently have the ability to raise \$860 million through security offerings, through one or more prospectus supplements that would describe, among other things, the specific amounts, prices and terms of any securities offered and how the proceeds would be used. Any proceeds from the sale of securities would be used for general business purposes, which may include, among other things, funding acquisitions of assets or businesses, working capital, capital expenditures, investments in subsidiaries, the retirement of existing debt and/or the repurchase of common units or other securities.

We believe our current cash balances, future internally generated funds and funds available under the Credit Agreement will provide sufficient resources to meet our working capital liquidity needs for the foreseeable future.

In February, May and August 2010 we paid regular quarterly cash distributions of \$0.805, \$0.815 and \$0.825, on all units in an aggregate amount of \$62.6 million. Included in these distributions were \$7.4 million of payments to the general partner as an incentive distribution.

Cash flows from continuing and discontinued operations have been combined for presentation purposes in the Consolidated Statements of Cash Flows. For the nine months ended September 30, 2009, net cash flows from our discontinued Rio Grande operations were \$5.7 million.

Cash and cash equivalents decreased by \$1.8 million during the nine months ended September 30, 2010. The combined cash flows used for investing and financing activities of \$43.6 million and \$24.4 million, respectively, exceeded cash flows provided by operating activities of \$66.1 million. Working capital for the nine months ended September 30, 2010 decreased by \$159.8 million primarily due to the reclassification of \$157 million in credit agreement borrowings to current liabilities.

Cash Flows – Operating Activities

Cash flows from operating activities increased by \$21.3 million from \$44.8 million for the nine months ended September 30, 2009 to \$66.1 million for the nine months ended September 30, 2010. This increase is due principally to \$29 million in additional cash collections from our major customers, resulting principally from increased revenues, partially offset by year-over-year changes in payments attributable to costs of increased operations.

Our major shippers are obligated to make deficiency payments to us if they do not meet their minimum volume shipping obligations. Under certain agreements with these shippers, they have the right to recapture these amounts if future volumes exceed minimum levels. For the nine months ended September 30, 2010, we received cash payments of \$9.3 million under these commitments. We billed \$5.7 million during the nine months ended September 30, 2009 related to shortfalls that subsequently expired without recapture and were recognized as revenue during the nine months ended September 30, 2010. Another \$2.4 million is included in our accounts receivable at September 30, 2010 related to shortfalls that occurred during the third quarter of 2010.

Cash Flows – Investing Activities

Cash flows used for investing activities decreased by \$55.4 million from \$99 million for the nine months ended September 30, 2009 to \$43.6 million for the nine months ended September 30, 2010. During the nine months ended September 30, 2010, we acquired storage assets from Holly for \$35.5 million and invested \$8.1 million in additions to properties and equipment. For the nine months ended September 30, 2009, we acquired Holly's 16-inch intermediate pipeline and the Tulsa loading racks for \$46 million, acquired our SLC Pipeline joint venture interest costing \$25.5 million, and invested \$27.5 million in additions to properties and equipment.

Table of Contents

Cash Flows Financing Activities

Cash flows used for financing activities were \$24.4 million compared to cash provided by financing activities of \$53 million for the nine months ended September 30, 2009, a decrease of \$77.3 million. During the nine months ended September 30, 2010, we received \$52 million and repaid \$101 million in advances under the Credit Agreement. Additionally, we received \$147.5 million in net proceeds and incurred \$0.5 million in financing costs upon the issuance of the 8.25% Senior Notes. During the nine months ended September 30, 2010, we paid \$62.6 million in regular quarterly cash distributions to our general and limited partners, paid \$57.5 million in excess of Holly's transferred basis in the storage assets acquired in March 2010 and paid \$2.3 million for the purchase of common units for recipients of our restricted unit incentive grants. For the nine months ended September 30, 2009, we received \$197 million and repaid \$152 million in advances under the Credit Agreement. Additionally, we received \$58.4 million in proceeds and incurred \$0.3 million in costs with respect to our May 2009 equity offering. During the nine months ended September 30, 2009, we paid \$44.4 million in regular quarterly cash distributions to our general and limited partners, paid \$5.7 million in excess of Holly's transferred basis in the Tulsa loading racks and paid \$0.6 million for the purchase of common units for recipients of restricted grants. We also received a \$1.2 million capital contribution from our general partner.

Capital Requirements

Our pipeline and terminalling operations are capital intensive, requiring investments to maintain, expand, upgrade or enhance existing operations and to meet environmental and operational regulations. Our capital requirements consist of maintenance capital expenditures and expansion capital expenditures. Repair and maintenance expenses associated with existing assets that are minor in nature and do not extend the useful life of existing assets are charged to operating expenses as incurred.

Each year the Holly Logistics Services, L.L.C. (HLS) board of directors approves our annual capital budget, which specifies capital projects that our management is authorized to undertake. Additionally, at times when conditions warrant or as new opportunities arise, special projects may be approved. The funds allocated for a particular capital project may be expended over a period in excess of a year, depending on the time required to complete the project. Therefore, our planned capital expenditures for a given year consist of expenditures approved for capital projects included in the current year's capital budget as well as, in certain cases, expenditures approved for capital projects in capital budgets for prior years. The 2010 capital budget is comprised of \$5.3 million for maintenance capital expenditures and \$6 million for expansion capital expenditures. In March 2010, the HLS board of directors approved our \$93 million acquisition of the Tulsa east storage tank and loading rack assets and Lovington asphalt rack loading facility from Holly on March 31, 2010.

Pursuant to a term sheet with Holly, we are currently constructing five interconnecting pipelines between Holly's Tulsa east and west refining facilities. The project is expected to cost approximately \$25 million with completion in the first quarter of 2011. We are currently negotiating terms for a long-term agreement with Holly to transfer intermediate products via these pipelines that will commence upon completion of the project. In the event that we are unable to obtain such an agreement, Holly will reimburse us for the cost of the pipelines.

We have an option agreement with Holly, granting us an option to purchase Holly's 75% equity interests in the UNEV Pipeline, a joint venture pipeline currently under construction that will be capable of transporting refined petroleum products from Salt Lake City, Utah to Las Vegas, Nevada. Under this agreement, we have an option to purchase Holly's equity interests in the UNEV Pipeline, effective for a 180-day period commencing when the UNEV Pipeline becomes operational, at a purchase price equal to Holly's investment in the joint venture pipeline, plus interest at 7% per annum. The initial capacity of the pipeline will be 62,000 bpd, with the capacity for further expansion to 120,000 bpd. The current total cost of the pipeline project including terminals is expected to be approximately \$300 million. This includes a project scope change that includes the construction of ethanol blending and storage facilities at the Cedar City terminal. The pipeline is in the final construction phase and is expected to be mechanically complete in the second quarter of 2011.

Table of Contents

We expect that our currently planned sustaining and maintenance capital expenditures as well as expenditures for acquisitions and capital development projects such as the UNEV Pipeline described above, will be funded with existing cash generated by operations, the sale of additional limited partner common units, the issuance of debt securities and advances under our \$300 million Credit Agreement, or a combination thereof. We are not obligated to purchase the UNEV Pipeline nor are we subject to any fees or penalties if HLS board of directors decides not to proceed with this opportunity.

Credit Agreement

Our obligations under the Credit Agreement are collateralized by substantially all of our assets. Indebtedness under the Credit Agreement is recourse to HEP Logistics Holdings, L.P., our general partner, and guaranteed by our wholly-owned subsidiaries. Any recourse to HEP Logistics Holdings, L.P. would be limited to the extent of its assets, which other than its investment in us, are not significant.

We may prepay all loans at any time without penalty, except for payment of certain breakage and related costs. We are required to reduce all working capital borrowings under the Credit Agreement to zero for a period of at least 15 consecutive days in each twelve-month period prior to the maturity date of the agreement. As of September 30, 2010, we had no working capital borrowings.

Indebtedness under the Credit Agreement bears interest, at our option, at either (a) the reference rate as announced by the administrative agent plus an applicable margin (ranging from 0.25% to 1.50%) or (b) at a rate equal to the London Interbank Offered Rate (LIBOR) plus an applicable margin (ranging from 1.00% to 2.50%). In each case, the applicable margin is based upon the ratio of our funded debt (as defined in the agreement) to EBITDA (earnings before interest, taxes, depreciation and amortization, as defined in the agreement). At September 30, 2010, we were subject to an applicable margin of 1.75%. We incur a commitment fee on the unused portion of the Credit Agreement at a rate ranging from 0.20% to 0.50% based upon the ratio of our funded debt to EBITDA for the four most recently completed fiscal quarters. At September 30, 2010, we are subject to a .30% commitment fee on the \$143 million unused portion of the Credit Agreement.

The Credit Agreement imposes certain requirements on us, including: a prohibition against distribution to unitholders if, before or after the distribution, a potential default or an event of default as defined in the agreement would occur; limitations on our ability to incur debt, make loans, acquire other companies, change the nature of our business, enter a merger or consolidation, or sell assets; and covenants that require maintenance of a specified EBITDA to interest expense ratio and debt to EBITDA ratio. If an event of default exists under the agreement, the lenders will be able to accelerate the maturity of the debt and exercise other rights and remedies. Additionally, the Credit Agreement contains certain provisions whereby the lenders may accelerate payment of outstanding debt under certain circumstances.

Senior Notes

The 6.25% Senior Notes and 8.25% Senior Notes (collectively, the Senior Notes) are unsecured and have certain restrictive covenants, which we are subject to and currently in compliance with, including limitations on our ability to incur additional indebtedness, make investments, sell assets, incur certain liens, pay distributions, enter into transactions with affiliates, and enter into mergers. At any time when the Senior Notes are rated investment grade by both Moody's and Standard & Poor's and no default or event of default exists, we will not be subject to many of the foregoing covenants. Additionally, we have certain redemption rights under the Senior Notes.

Indebtedness under the Senior Notes is recourse to HEP Logistics Holdings, L.P., our general partner, and guaranteed by our wholly-owned subsidiaries. However, any recourse to HEP Logistics Holdings, L.P. would be limited to the extent of its assets, which other than its investment in us, are not significant.

Table of Contents

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

	September 30, 2010	December 31, 2009
	(In thousands)	
Credit Agreement	\$ 157,000	\$ 206,000
6.25% Senior Notes		
Principal	185,000	185,000
Unamortized discount	(1,679)	(1,964)
Unamortized premium dedesignated fair value hedge	1,531	1,791
	184,852	184,827
8.25% Senior Notes		
Principal	150,000	
Unamortized discount	(2,288)	
	147,712	
Total debt	489,564	390,827
Less credit agreement borrowings classified as current liabilities	157,000	
Total long-term debt	\$ 332,564	\$ 390,827

See Risk Management for a discussion of our interest rate swaps.

Contractual Obligations

During the nine months ended September 30, 2010, we repaid net advances of \$49 million resulting in \$157 million of borrowings outstanding under the Credit Agreement at September 30, 2010.

In March 2010, we issued \$150 million aggregate principal amount of 8.25% Senior Notes maturing March 15, 2018.

There were no other significant changes to our long-term contractual obligations during this period.

Impact of Inflation

Inflation in the United States has been relatively low in recent years and did not have a material impact on our results of operations for the nine months ended September 30, 2010 and 2009.

A substantial majority of our revenues are generated under long-term contracts that provide for increases in our rates and minimum revenue guarantees annually for increases in the PPI. Historically, the PPI has increased an average of 3.1% annually over the past 5 calendar years. This is no indication of PPI increases to be realized in the near future. Furthermore, certain of our long-term contracts have provisions that limit the level of annual PPI percentage rate increases.

Environmental Matters

Our operation of pipelines, terminals, and associated facilities in connection with the storage and transportation of refined products and crude oil is subject to stringent and complex federal, state, and local laws and regulations governing the discharge of materials into the environment, or otherwise relating to the protection of the

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

Table of Contents

Under the Omnibus Agreement, Holly agreed to indemnify us up to certain aggregate amounts for any environmental noncompliance and remediation liabilities associated with assets transferred to us and occurring or existing prior to the date of such transfers. The transfers that are covered by the agreement include the refined product pipelines, terminals and tanks transferred by Holly's subsidiaries in connection with our initial public offering in July 2004, the intermediate pipelines acquired in July 2005, the crude pipelines and tankage assets acquired in 2008, and the asphalt loading rack facility acquired in March 2010. The Omnibus Agreement provides environmental indemnification of up to \$15 million for the assets transferred to us, other than the crude pipelines and tankage assets, plus an additional \$2.5 million for the intermediate pipelines acquired in July 2005. Except as described below, Holly's indemnification obligations described above will remain in effect for an asset for ten years following the date it is transferred to us. The Omnibus Agreement also provides an additional \$7.5 million of indemnification through 2023 for environmental noncompliance and remediation liabilities specific to the crude pipelines and tankage assets. Holly's indemnification obligations described above do not apply to (i) the Tulsa west loading racks acquired in August 2009, (ii) the 16-inch intermediate pipeline acquired in June 2009, (iii) the Roadrunner Pipeline, (iv) the Beeson Pipeline, (v) the logistics and storage assets acquired from Sinclair in December 2009, or (vi) the Tulsa east storage tanks and loading racks acquired in March 2010. Under provisions of the Holly ETA and Holly PTTA, Holly will indemnify us for environmental liabilities arising from our pre-ownership operations of the Tulsa west loading rack facilities acquired from Holly in August 2009, the Tulsa logistics and storage assets acquired from Sinclair in December 2009 and the Tulsa east storage tanks and loading racks acquired from Holly in March 2010. Additionally, Holly agreed to indemnify us for any liabilities arising from Holly's operation of the loading racks under the Holly ETA.

We have an environmental agreement with Alon with respect to pre-closing environmental costs and liabilities relating to the pipelines and terminals acquired from Alon in 2005, under which Alon will indemnify us through 2015, subject to a \$100,000 deductible and a \$20 million maximum liability cap.

There are environmental remediation projects that are currently in progress that relate to certain assets acquired from Holly. Certain of these projects were underway prior to our purchase and represent liabilities of Holly Corporation as the obligation for future remediation activities was retained by Holly. As of September 30, 2010, we have an accrual of \$0.3 million that relates to environmental clean-up projects. The remaining projects, including assessment and monitoring activities, are covered under the Holly environmental indemnification discussed above and represent liabilities of Holly Corporation.

CRITICAL ACCOUNTING POLICIES

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

Our significant accounting policies are described in Item 7. Management's Discussion and Analysis of Financial Condition and Operations—Critical Accounting Policies in our Annual Report on Form 10-K for the year ended December 31, 2009. Certain critical accounting policies that materially affect the amounts recorded in our consolidated financial statements include revenue recognition, assessing the possible impairment of certain long-lived assets and assessing contingent liabilities for probable losses. There have been no changes to these policies in 2010. We consider these policies to be the most critical to understanding the judgments that are involved and the uncertainties that could impact our results of operations, financial condition and cash flows.

Table of Contents**RISK MANAGEMENT**

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

As of September 30, 2010, we have an interest rate swap that hedges our exposure to the cash flow risk caused by the effects of LIBOR changes on a \$155 million Credit Agreement advance. This interest rate swap effectively converts our \$155 million LIBOR based debt to fixed rate debt having an interest rate of 3.74% plus an applicable margin, currently 1.75%, which equals an effective interest rate of 5.49% as of September 30, 2010. The maturity date of this swap contract is February 28, 2013.

We have designated this interest rate swap as a cash flow hedge. Based on our assessment of effectiveness using the change in variable cash flows method, we have determined that this interest rate swap is effective in offsetting the variability in interest payments on our \$155 million variable rate debt resulting from changes in LIBOR. Under hedge accounting, we adjust our cash flow hedge on a quarterly basis to its fair value with the offsetting fair value adjustment to accumulated other comprehensive loss. Also on a quarterly basis, we measure hedge effectiveness by comparing the present value of the cumulative change in the expected future interest to be paid or received on the variable leg of our swap against the expected future interest payments on our \$155 million variable rate debt. Any ineffectiveness is reclassified from accumulated other comprehensive loss to interest expense. To date, we have had no ineffectiveness on our cash flow hedge.

Additional information on our interest rate swap as of September 30, 2010 is as follows:

		Balance Sheet		Location of Offsetting	Offsetting
Interest Rate Swap		Location	Fair Value	Balance	Amount
				(In thousands)	
Liability					
Cash flow hedge	\$155 million LIBOR based debt	Other long-term liabilities	\$ 11,825	Accumulated other comprehensive loss	\$ 11,825

We review publicly available information on our counterparty in order to review and monitor its financial stability and assess its ongoing ability to honor its commitment under the interest rate swap contract. This counterparty is a large financial institution. Furthermore, we have not experienced, nor do we expect to experience, any difficulty in the counterparty honoring its commitment.

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

At September 30, 2010, we had an outstanding principal balance on our 6.25% Senior Notes and 8.25% Senior Notes of \$185 million and \$150 million, respectively. A change in interest rates would generally affect the fair value of the Senior Notes, but not our earnings or cash flows. At September 30, 2010, the fair value of our 6.25% Senior Notes and 8.25% Senior Notes were \$183.2 million and \$156.8 million, respectively. We estimate a hypothetical 10% change in the yield-to-maturity applicable to the 6.25% Senior Notes and 8.25% Senior Notes at September 30, 2010 would result in a change of approximately \$4.5 million and \$6.4 million, respectively, in the fair value of the underlying notes.

For the variable rate Credit Agreement, changes in interest rates would affect cash flows, but not the fair value. At September 30, 2010, borrowings outstanding under the Credit Agreement were \$157 million. By means of our cash flow hedge, we have effectively converted the variable rate on \$155 million of outstanding borrowings to a fixed rate of 5.49%.

Table of Contents

At September 30, 2010, our cash and cash equivalents included highly liquid investments with a maturity of six months or less at the time of purchase. Due to the short-term nature of our cash and cash equivalents, a hypothetical 10% increase in interest rates would not have a material effect on the fair market value of our portfolio. Since we have the ability to liquidate this portfolio, we do not expect our operating results or cash flows to be materially affected by the effect of a sudden change in market interest rates on our investment portfolio.

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

We have a risk management oversight committee that is made up of members from our senior management. This committee monitors our risk environment and provides direction for activities to mitigate, to an acceptable level, identified risks that may adversely affect the achievement of our goals.

Table of Contents

Item 3. Quantitative and Qualitative Disclosures About Market Risks

Market risk is the risk of loss arising from adverse changes in market rates and prices. See Risk Management under Management's Discussion and Analysis of Financial Condition and Results of Operations for a discussion of market risk exposures that we have with respect to our cash and cash equivalents and long-term debt. We utilize derivative instruments to hedge our interest rate exposure, also discussed under Risk Management. Since we do not own products shipped on our pipelines or terminalled at our terminal facilities, we do not have market risks associated with commodity prices.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures

Our principal executive officer and principal financial officer have evaluated, as required by Rule 13a-15(b) under the Securities Exchange Act of 1934 (the Exchange Act), our disclosure controls and procedures (as defined in Rules 13a-15(e) and 15d-15(e) under the Exchange Act) as of the end of the period covered by this quarterly report on Form 10-Q. Our disclosure controls and procedures are designed to provide reasonable assurance that the information we are required to disclose in the reports that we file or submit under the Exchange Act is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure and is recorded, processed, summarized and reported within the time periods specified in the Securities and Exchange Commission's rules and forms. Based upon the evaluation, our principal executive officer and principal financial officer have concluded that our disclosure controls and procedures were effective as of September 30, 2010.

(b) Changes in internal control over financial reporting

There have been no changes in our internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during our last fiscal quarter that have materially affected or are reasonably likely to materially affect our internal control over financial reporting.

Table of Contents

PART II. OTHER INFORMATION

Item 1. Legal Proceedings

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

Item 6. Exhibits

- | | |
|--------|-------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------------|
| 10.1 | Tulsa Refinery Interconnects Term Sheet dated August 9, 2010 (incorporated by reference to Exhibit 10.1 of Registrant's Form 8-K Current Report dated August 11, 2010, File No. 1-32225). |
| 12.1+ | Computation of Ratio of Earnings to Fixed Charges. |
| 31.1+ | Certification of Chief Executive Officer under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 31.2+ | Certification of Chief Financial Officer under Section 302 of the Sarbanes-Oxley Act of 2002. |
| 32.1++ | Certification of Chief Executive Officer under Section 906 of the Sarbanes-Oxley Act of 2002. |
| 32.2++ | Certification of Chief Financial Officer under Section 906 of the Sarbanes-Oxley Act of 2002. |

+ Filed herewith.

++ Furnished
herewith.

Table of Contents

HOLLY ENERGY PARTNERS, L.P.

SIGNATURES

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

HOLLY ENERGY PARTNERS, L.P.
(Registrant)

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

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

Date: October 29, 2010

/s/ Bruce R. Shaw

Bruce R. Shaw
Senior Vice President and
Chief Financial Officer
(Principal Financial Officer)

/s/ Scott C. Surplus

Scott C. Surplus
Vice President and Controller
(Principal Accounting Officer)

- 46 -