NuStar Energy L.P.
Form 10-Q
May 09, 2008
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2008

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission File Number 1-16417

NUSTAR ENERGY L.P.

(Exact name of registrant as specified in its charter)

Delaware **(State or other jurisdiction of incorporation or organization)**	**74-2956831** **(I.R.S. Employer Identification No.)**

2330 North Loop 1604 West

San Antonio, Texas

(Address of principal executive offices)

78248

(Zip Code)

Telephone number: (210) 918-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule12b-2 of the Exchange Act (Check one):

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

(Do not check if a smaller reporting company)

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes ¨ No x

The number of common units outstanding as of May 1, 2008 was 54,460,549.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Thousands of Dollars, Except Unit Data)

	March 31, 2008 (Unaudited)	December 31, 2007
Assets		
Current assets:		
Cash and cash equivalents	$ 75,218	$ 89,838
Accounts receivable, net of allowance for doubtful accounts of $359 and $365 as of March 31, 2008 and December 31, 2007, respectively	201,847	130,354
Receivable from related party		786
Inventories	427,645	88,532
Other current assets	68,370	37,624
Total current assets	773,080	347,134
Property, plant and equipment, at cost	3,443,243	2,944,116
Accumulated depreciation and amortization	(479,344)	(452,030)
Property, plant and equipment, net	2,963,899	2,492,086
Intangible assets, net	46,090	47,762
Goodwill	784,494	785,019
Investment in joint ventures	82,067	80,366
Deferred income tax asset	11,089	10,622
Deferred charges and other assets, net	53,002	20,098
Total assets	$ 4,713,721	$ 3,783,087
Liabilities and Partners Equity		
Current liabilities:		
Current portion of long-term debt	$ 660	$ 663
Accounts payable	193,282	163,309
Payable to related party	753	
Notes payable	182,800	
Accrued interest payable	11,056	17,725
Accrued liabilities	190,773	47,189
Taxes other than income taxes	12,254	10,157
Income taxes payable	5,371	3,442
Total current liabilities	596,949	242,485
Long-term debt, less current portion	2,019,838	1,445,626
Long-term payable to related party	5,668	5,684
Deferred income tax liability	34,305	34,196

Other long-term liabilities	64,513	60,264
Commitments and contingencies (Note 6)		
Partners equity:		
Limited partners (49,409,749 common units outstanding as of March 31, 2008 and December 31, 2007)	1,927,108	1,926,126
General partner	41,733	41,819
Accumulated other comprehensive income	23,607	26,887
Total partners equity	1,992,448	1,994,832
Total liabilities and partners equity	$ 4,713,721	$ 3,783,087

See Condensed Notes to Consolidated Financial Statements.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited, Thousands of Dollars, Except Unit and Per Unit Data)

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Revenues:		
Services revenues	$ 180,116	$ 160,353
Product sales	412,658	136,471
Total revenues	592,774	296,824
Costs and expenses:		
Cost of product sales	393,009	127,927
Operating expenses:		
Third parties	64,129	59,879
Related party	24,321	21,333
Total operating expenses	88,450	81,212
General and administrative expenses:		
Third parties	6,261	5,102
Related party	9,822	9,806
Total general and administrative expenses	16,083	14,908
Depreciation and amortization expense	30,046	27,342
Total costs and expenses	527,588	251,389
Operating income	65,186	45,435
Equity earnings from joint ventures	2,201	1,611
Interest expense, net	(16,865)	(18,854)
Other income, net	9,909	6,623
Income before income tax expense	60,431	34,815
Income tax expense	4,562	3,692
Net income	55,869	31,123
Less net income applicable to general partner	(6,202)	(4,454)
Net income applicable to limited partners	$ 49,667	$ 26,669
Weighted average number of basic units outstanding	49,409,749	46,809,749
Net income per unit applicable to limited partners	$ 1.01	$ 0.57

See Condensed Notes to Consolidated Financial Statements.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, Thousands of Dollars)

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
Cash Flows from Operating Activities:		
Net income	$ 55,869	$ 31,123
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	30,046	27,342
Amortization of debt related items	(1,586)	(1,246)
Other non-cash gains	(4,250)	(1,316)
Provision for deferred income taxes	585	921
Equity earnings from joint ventures	(2,201)	(1,611)
Distributions of equity earnings from joint ventures	500	
Changes in current assets and current liabilities (Note 12)	(83,382)	5,288
Other, net	1,596	(2,527)
Net cash (used in) provided by operating activities	(2,823)	57,974
Cash Flows from Investing Activities:		
Reliability capital expenditures	(7,704)	(4,620)
Strategic and other capital expenditures	(32,782)	(42,255)
Acquisition	(655,962)	
Investment in other noncurrent assets		(34)
Proceeds from sale of assets	4,360	586
Other	24	38
Net cash used in investing activities	(692,064)	(46,285)
Cash Flows from Financing Activities:		
Proceeds from long-term debt borrowings, net of issuance costs	1,207,849	121,247
Proceeds from notes payable	218,000	
Long-term debt repayments	(645,000)	(88,567)
Repayments of notes payable	(40,257)	(2,458)
Distributions to unitholders and general partner	(54,956)	(47,695)
(Decrease) increase in cash book overdrafts	(3,433)	345
Other	(50)	12
Net cash provided by (used in) financing activities	682,153	(17,116)
Effect of foreign exchange rate changes on cash	(1,886)	430
Net decrease in cash and cash equivalents	(14,620)	(4,997)
Cash and cash equivalents at the beginning of the period	89,838	68,838
Cash and cash equivalents at the end of the period	$ 75,218	$ 63,841

See Condensed Notes to Consolidated Financial Statements.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION, OPERATIONS AND ACCOUNTING PRONOUNCEMENTS

Organization

NuStar Energy L.P. (NuStar Energy) (NYSE: NS) is a publicly held Delaware limited partnership engaged in the crude oil and refined product transportation, terminalling and storage business and the asphalt refining and marketing business in the United States, the Netherland Antilles, Canada, Mexico, the Netherlands and the United Kingdom. NuStar Energy also purchases certain petroleum products for resale to third parties. As used in this report, references to we, us, our or the Partnership collectively refer, depending on the context, to NuStar Energy or a whol owned subsidiary of NuStar Energy.

NuStar GP Holdings, LLC (NuStar GP Holdings) (NYSE: NSH), a publicly held Delaware limited liability company, owns our general partner, which is represented by a 2% general partner interest. As of March 31, 2008, NuStar GP Holdings, through various subsidiaries, also owned limited partner units, resulting in a combined ownership of 22.3% of our partnership interests. The remaining 77.7% limited partnership interests were held by public unitholders.

These unaudited consolidated financial statements include the accounts of the Partnership and subsidiaries in which the Partnership has a controlling interest. Intercompany balances and transactions have been eliminated in consolidation. Investments in 50% or less owned entities are accounted for using the equity method of accounting.

These unaudited consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and notes required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal recurring nature unless disclosed otherwise. Financial information for the three months ended March 31, 2008 and 2007 included in these Condensed Notes to Consolidated Financial Statements is derived from our unaudited consolidated financial statements. Operating results for the three months ended March 31, 2008 are not necessarily indicative of the results that may be expected for the year ending December 31, 2008.

The consolidated balance sheet as of December 31, 2007 has been derived from the audited consolidated financial statements as of that date. You should read these consolidated financial statements in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2007.

Operations

Our operations are managed by NuStar GP, LLC, a wholly owned subsidiary of NuStar GP Holdings.

We conduct our operations through our wholly owned subsidiaries, primarily NuStar Logistics, L.P. (NuStar Logistics) and NuStar Pipeline Operating Partnership L.P. (NuPOP), formerly Kaneb Pipe Line Operating Partnership, L.P. We have five business segments: refined product terminals, refined product pipelines, crude oil pipelines, crude oil storage tanks and refining and marketing.

New Accounting Pronouncements

FASB Statement No. 141R

In December 2007, the Financial Accounting Standards Board (FASB) issued Statement No. 141 (Revised 2007), Business Combinations. Statement 141R will significantly change the accounting for business combinations. Under Statement 141R, an acquiring entity will be required to recognize all the assets acquired and liabilities assumed in a transaction at the acquisition-date fair value with limited exceptions. Statement 141R will change the accounting treatment for certain specific items, such as acquisition costs, acquired contingent liabilities, restructuring costs, changes in deferred tax asset valuation allowances and other items. Statement 141R also includes a substantial number of new disclosure requirements. Statement 141R applies prospectively to business combinations for which the acquisition date is on or after the beginning of the first annual reporting period beginning on or after December 15, 2008. Early adoption is prohibited. Accordingly, we will not adopt the provisions of Statement 141R until January 1, 2009.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

FASB Statement No. 161

In March 2008, the FASB issued Statement No. 161, Disclosures about Derivative Instruments and Hedging Activities. Statement No. 161 amends and expands the disclosure requirements under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities. Statement No. 161 requires enhanced disclosures on how and why an entity uses derivative instruments, how derivative instruments and related hedged items are accounted for and their impact on an entity s financial performance, financial position and cash flows. Statement No. 161 is effective January 1, 2009. Early application is encouraged, and retrospective application for previous periods is encouraged but not required. We currently include many of the disclosures required by Statement No. 161. Thus, we do not expect it to materially affect our financial position or results of operations.

EITF 07-4

In March 2008, the FASB ratified its consensus on EITF Issue No. 07-4, Application of the Two-Class Method under FASB Statement No. 128, Earnings per Share, to Master Limited Partnerships (EITF No. 07-4). EITF No. 07-4 applies to master limited partnerships with incentive distribution rights (IDRs) that are accounted for as equity interests. EITF 07-4 states that IDRs are participating securities under Statement No. 128 and should be allocated to earnings in the calculation of earnings per share. This allocation of earnings would be limited to the amounts distributable to the IDR holders in accordance with the partnership agreement. Retrospective application for comparative periods presented is required. EITF No. 07-4 is effective January 1, 2009, and early application is not permitted. Accordingly, we will not adopt the provisions of EITF No. 07-4 until January 1, 2009, and we are continuing to evaluate its effect.

FASB Staff Position FAS 142-3

In April 2008, the FASB issued Staff Position FAS 142-3, Determination of the Useful Life of Intangible Assets (FSP 142-3). FSP 142-3 amends the factors that should be considered in developing renewal or extension assumptions used to determine the useful life of a recognized intangible asset under FASB Statement No. 142, Goodwill and Other Intangible Assets, to improve the consistency between the useful life of a recognized intangible asset under Statement No. 142 and the period of expected cash flows used to measure the fair value of the asset under FASB Statement No. 141R. FSP 142-3 is effective for financial statements issued for fiscal years beginning after December 15, 2008, and interim periods within those fiscal years. Early adoption is prohibited. Accordingly, we will not adopt the provisions of FSP 142-3 until January 1, 2009.

Reclassifications

Certain previously reported amounts in the 2007 consolidated financial statements have been reclassified to conform to the 2008 presentation.

2. ACQUISITIONS

CITGO Asphalt Refining Company Asphalt Operations and Assets

On March 20, 2008, we completed our acquisition of CITGO Asphalt Refining Company s asphalt operations and assets (the East Coast Asphalt Operations) for $450 million, plus inventory of approximately $350 million, subject to post-closing adjustment. The East Coast Asphalt Operations include a 74,000 barrels-per-day (BPD) asphalt refinery in Paulsboro, New Jersey, a 30,000 BPD asphalt refinery in Savannah, Georgia and three asphalt terminals. The asphalt terminals located in Paulsboro, New Jersey, Savannah, Georgia and Wilmington, North Carolina have storage capacities of 3.4 million barrels, 1.2 million barrels, and 0.2 million barrels, respectively. The East Coast Asphalt Operations market asphalt through fifteen terminals with a total storage capacity of approximately 2.1 million barrels that are leased from various third parties.

We made an initial payment at closing of $654.5 million and assumed $4.8 million of liabilities. The balance due related to the post-closing adjustment is expected to be paid in the second quarter of 2008, upon receipt of a final inventory valuation. We funded the acquisition with borrowings under our revolving credit agreement and term credit agreement. The results of operations for the refineries, including the two related terminals in Paulsboro and Savannah, as well as the associated marketing activities, are included in the refining and marketing segment. The results of operations for the Wilmington terminal are included in the refined product terminals segment.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The acquisition of the East Coast Asphalt Operations complements our existing asphalt marketing operations, gives us exposure to the largest asphalt market in the United States, diversifies our customer base and expands our geographic presence.

The acquisition of the East Coast Asphalt Operations was accounted for using the purchase method. The purchase price has been preliminarily allocated based on the estimated fair values of the individual assets acquired and liabilities assumed at the date of acquisition pending completion of an independent appraisal and other evaluations. The purchase price and preliminary purchase price allocation were as follows (in thousands):

Cash paid for the East Coast Asphalt Operations	$ 654,493
Estimated post-closing adjustment	147,134
Transaction costs	1,469
Fair value of liabilities assumed	4,789
Total	$ 807,885
Inventory	$ 323,818
Other current assets	1,439
Property, plant and equipment	454,312
Other noncurrent assets	28,316
Total	$ 807,885

The condensed statements of income include the results of operations for the East Coast Asphalt Operations commencing on March 20, 2008. The unaudited pro forma financial information for the three months ended March 31, 2008 and 2007 presented below combines the historical financial information for the East Coast Asphalt Operations and the Partnership for that period. This information assumes the following:

- we completed the acquisition of the East Coast Asphalt Operations as of the beginning of the periods reported;
- we issued 7.7 million common units;
- we received a contribution from our general partner of $8.0 million to maintain its 2% interest;
- we issued $350.0 million of 7.65% senior notes; and
- we borrowed approximately $74.0 million under our revolving credit agreement.

The following unaudited pro forma information is not necessarily indicative of the results of future operations:

	Three Months Ended March 31, 2008	2007
	(Thousands of Dollars, Except Per Unit Data)	
Revenues	$ 772,627	$ 542,457
Operating income	73,739	49,685
Net income	56,390	27,525
Net income per unit applicable to limited partners	$ 0.91	$ 0.41

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. INVENTORIES

Inventories consisted of the following:

	March 31, 2008	December 31, 2007
	(Thousands of Dollars)	
Refinery feedstocks	$ 129,104	$
Finished products	298,541	88,532
Total	$ 427,645	$ 88,532

Refinery feedstocks consist of crude oil. Refined products primarily consist of asphalt, bunker fuel and other petroleum products.

4. NOTES PAYABLE

Term Loan Agreement

On March 20, 2008, we entered into a $124.0 million term loan agreement (the Term Loan Agreement), all of which was used to fund a portion of our acquisition of the East Coast Asphalt Operations. The Term Loan Agreement bears interest based on either an alternative base rate or a LIBOR based rate, which was 3.4% as of March 31, 2008. The $124.0 million balance on the Term Loan Agreement was paid in full on April 2, 2008 with the proceeds from our equity offering (See Note 11. Partners Equity).

Lines of Credit

As of March 31, 2008, we had outstanding borrowings of $55.0 million on several uncommitted, short-term lines of credit. The interest rates and maturities vary and are determined at the time of the borrowing. The interest rates are based on the Federal Funds rate. The weighted-average interest rate was 3.5% as of March 31, 2008.

5. LONG-TERM DEBT

7.65% Senior Notes

On April 4, 2008, NuStar Logistics completed the sale of $350.0 million of 7.65% senior notes, issued under our $3.0 billion shelf registration statement, for net proceeds of $347.0 million. The net proceeds were used to repay a portion of the outstanding principal balance under our revolving credit agreement. The interest on the 7.65% senior notes is payable semi-annually in arrears on April 15 and October 15 of each year beginning on October 15, 2008. The notes will mature on April 15, 2018.

The 7.65% senior notes rank equally with existing senior unsecured indebtedness of NuStar Logistics. These notes do not have sinking fund requirements. The 7.65% senior notes issued by NuStar Logistics are fully and unconditionally guaranteed by NuStar Energy and NuPOP. NuPOP will be released from its guarantee when it no longer guarantees any obligations of NuStar Energy, or any of its subsidiaries, including NuStar Logistics, under any bank facility or public debt instrument. The 7.65% senior notes contain restrictions on NuStar Logistics ability to incur secured indebtedness unless the same security is also provided for the benefit of holders of the notes. In addition, the 7.65% senior notes limit NuStar Logistics ability to incur indebtedness secured by certain liens and to engage in certain sale-leaseback transactions. At the option of NuStar Logistics, the 7.65% senior notes may be redeemed in whole or in part at any time at a redemption price, which includes a make-whole premium, plus accrued and unpaid interest to the redemption date. The interest payable on the notes is 7.65% per year and is subject to increases if our debt rating is downgraded by certain credit agencies.

Revolving Credit Agreement

During the three months ended March 31, 2008, we borrowed $562.8 million, net of repayments, under our $1.25 billion five-year revolving credit agreement (the 2007 Revolving Credit Agreement) to fund our acquisition of the East Coast Asphalt Operations, a portion of our capital expenditures and working capital requirements. The 2007 Revolving Credit Agreement bears interest based on either an alternative base rate or a LIBOR based rate, which was 3.4% as of March 31, 2008. As of March 31, 2008, we had $150.3 million available for borrowing under the 2007

NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Revolving Credit Agreement. However, a portion of the outstanding principal balance was paid with the proceeds from the equity offering in April 2008, the related contribution from our general partner and the sale of the 7.65% senior notes on April 4, 2008, which resulted in more than $500 million available under the 2007 Revolving Credit Agreement. We expect to fund the final inventory payment related to the East Coast Asphalt Operations with borrowings on the 2007 Revolving Credit Agreement.

6. COMMITMENTS AND CONTINGENCIES

Litigation and Environmental Matters

We have contingent liabilities resulting from various litigation, claims and commitments, the most significant of which are discussed below. We record accruals for loss contingencies when losses are considered probable and can be reasonably estimated. Legal fees associated with defending the Partnership in legal matters are expensed as incurred. As of March 31, 2008, we have recorded $1.0 million of accruals related to settled matters and $48.2 million of accruals for contingent losses. The actual payment of any amounts accrued and the timing of such payments ultimately made is uncertain. We believe that should we be unable to successfully defend ourselves in any of these matters, the ultimate payment of any or all of the amounts reserved would not have a material adverse effect on our financial position or liquidity. However, if any actual losses ultimately exceed the amounts accrued, there could be a material adverse effect on our results of operations.

Grace Energy Corporation Matter. In 1997, Grace Energy Corporation (Grace Energy) sued subsidiaries of Kaneb Pipe Line Partners, L.P. (KPP) and Kaneb Services LLC (KSL and, collectively with KPP and their respective subsidiaries, Kaneb) in Texas state court. (Effective March 31, 2008, KPP and KSL changed their names to NuStar Pipeline Partners L.P. and LegacyStar Services, LLC, respectively.) The complaint sought recovery of the cost of remediation of fuel leaks in the 1970s from a pipeline that had once connected a former Grace Energy terminal with Otis Air Force Base in Massachusetts (Otis AFB). Grace Energy alleges the Otis AFB pipeline and related environmental liabilities had been transferred in 1978 to an entity that was part of Kaneb s acquisition of Support Terminal Services, Inc. and its subsidiaries from Grace Energy in 1993. Kaneb contends that it did not acquire the Otis AFB pipeline and never assumed any responsibility for any associated environmental damage.

In 2000, the court entered final judgment that: (i) Grace Energy could not recover its own remediation costs of $3.5 million, (ii) Kaneb owned the Otis AFB pipeline and its related environmental liabilities and (iii) Grace Energy was awarded $1.8 million in attorney costs. Both Kaneb and Grace Energy appealed the final judgment of the trial court to the Texas Court of Appeals in Dallas. In 2001, Grace Energy filed a petition in bankruptcy, which created an automatic stay of actions against Grace Energy. Once that stay is lifted, we intend to resume vigorous prosecution of the appeal.

The Otis AFB is a part of a Superfund Site pursuant to the Comprehensive Environmental Response Compensation and Liability Act (CERCLA). The site contains a number of groundwater contamination plumes, two of which are allegedly associated with the Otis AFB pipeline. Relying on the final judgment of the Texas state court assigning ownership of the Otis AFB pipeline to Kaneb, the U.S. Department of Justice (the DOJ) advised Kaneb in 2001 that it intends to seek reimbursement from Kaneb for the remediation costs associated with the two spill areas. In 2002, the DOJ asserted that it had incurred over $49.0 million in costs and expected to incur additional costs of approximately $19.0 million for remediation of the two spill areas. The DOJ has not filed a lawsuit against us related to this matter, and we have not made any payments toward costs incurred by the DOJ.

Department of Justice Matter. The DOJ advised us that Region VII of the U.S. Environmental Protection Agency (the EPA) has requested that the DOJ initiate a lawsuit against NuPOP for failing to prepare a Facility Response Plan, as required by Section 311(j)(5) of the Clean Water Act, 33 U.S.C. §1321(j), for certain of its pipeline terminals located in Region VII by August 30, 1994. A Facility Response Plan is a plan for responding to a worst case discharge, and to a substantial threat of such a discharge, of oil or hazardous substances. We are currently in settlement negotiations with the DOJ to resolve these matters.

EPA Investigation. On November 14, 2006, agents of the EPA presented a search warrant issued by a U.S. District Court at one of our terminals. Since then, we have been served with additional subpoenas. The search warrant and subpoenas all seek information regarding allegations of potential illegal conduct by us, certain of our subsidiaries

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

and/or our employees concerning compliance with certain environmental and safety laws and regulations. We have cooperated fully with the EPA in producing documents in response to the subpoenas. We are currently in negotiations with the U.S. Attorney to resolve this matter.

There can be no assurances that the conclusion of the EPA s investigation will not result in a determination that we violated applicable laws. If we are found to have violated such laws, we could be subject to fines, civil penalties and criminal penalties. A final determination that we violated applicable laws could, among other things, result in our debarment from future federal government contracts. An estimate of the possible loss or range of loss from an adverse result in this case cannot be reasonably made. However, if any of the consequences described above ultimately occur, it is reasonably possible that the effects could be material to our results of operations in the period we would be required to record a liability, and could be material to our cash flows in the periods we would be required to pay such liability.

Other

We are also a party to additional claims and legal proceedings arising in the ordinary course of business. We believe the possibility is remote that the final outcome of any of these claims or proceedings to which we are a party would have a material adverse effect on our financial position, results of operations or liquidity; however, due to the inherent uncertainty of litigation, there can be no assurance that the resolution of any particular claim or proceeding would not have a material adverse effect on our results of operations, financial position or liquidity.

Commitments

Simultaneously with the closing of the East Coast Asphalt Operations, we entered into a commitment to purchase from an affiliate of Petróleos de Venezuela S. A. (PDVSA), the national oil company of Venezuela, over a minimum seven-year period, an annual average of 75,000 barrels per day of crude oil (Crude Oil Sales Agreement). The value of this commitment will fluctuate as the pricing is determined by a market based pricing formula using published market indices, subject to adjustment based on the price of Mexican Maya crude.

During the first quarter of 2008, we took delivery of three vessels at our St. Eustatius facility and entered into a ten-year lease commitment for each vessel totaling approximately $40.0 million.

In connection with the East Coast Asphalt Operations acquisition, we assumed leases related to the rental of storage capacity at third party terminals. These commitments total approximately $45.0 million over the next five years. In addition, we entered into a contract of affreightment that requires us to ship a minimum quantity for the next four years at market rates dependent upon the actual distance traveled for each voyage.

7. FAIR VALUE MEASUREMENTS

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements. Statement No. 157, as amended, defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measures. The FASB deferred the effective date of Statement No. 157 for one year for all nonfinancial assets and liabilities, except for those items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually). We have applied the recognition and disclosure provisions of Statement No. 157 for financial assets and liabilities and for nonfinancial assets and liabilities that are re-measured at least annually as of January 1, 2008.

Statement No. 157 establishes a fair value hierarchy, which segregates the inputs used in measuring fair value into three levels: Level 1, defined as observable inputs such as quoted prices in active markets; Level 2, defined as inputs other than quoted prices in active markets that are either directly or indirectly observable; and Level 3, defined as unobservable inputs in which little or no market data exists.

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NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following assets and liabilities are measured at fair value on a recurring basis as of March 31, 2008:

	Level 1	Level 2	Level 3	Total
		(Thousands of Dollars)		
Inventory (FAS 133)	$ 920	$	$	$ 920
Other current assets -				
Product imbalances		17,979		17,979
Deferred charges and other assets, net -				
Interest rate swaps		7,715		7,715
Accrued liabilities:				
Derivatives	(7,163)			(7,163)
Firm commitments (FAS 133)	(90)			(90)
Product imbalances		(14,534)		(14,534)
Total	$ (6,333)	$ 11,160	$	$ 4,827

Product Imbalances

Product imbalances occur when customers deliver more or less refined product volumes into our pipelines than they are entitled to receive. We value assets and liabilities related to product imbalances at current market prices. As of December 31, 2007, we had $13.6 million of product imbalance assets and $10.5 million of product imbalance liabilities on our consolidated balance sheets.

Interest Rate Swaps

The fair value of the interest rate swaps was determined using discounted cash flows, which uses observable inputs such as time to maturity and market interest rates. As of December 31, 2007, the aggregate fair value of our interest rate swaps included in Deferred charges and other assets, net on our consolidated balance sheets was $2.2 million.

Derivatives

A portion of our product inventories and related firm commitments qualify for fair value hedge treatment under FASB Statement No. 133, Accounting for Derivative Instruments and Hedging Activities (Statement No. 133). The fair value of the respective hedged items is determined using quoted public spot market prices.

Our commodity derivative instruments consist of NYMEX futures contracts. The inputs utilized to determine the fair values of these contracts are obtained in quoted public markets. We have consistently applied these valuation techniques in all periods presented. As of December 31, 2007, the fair value of our derivative instruments included in Accrued liabilities on our consolidated balance sheets was $4.6 million.

8. DERIVATIVES, FINANCIAL INSTRUMENTS AND RISK MANAGEMENT ACTIVITIES

We utilize various derivative instruments to: (i) manage our exposure to commodity price risk, (ii) engage in a trading program and (iii) manage our exposure to interest rate risk. Our risk management policies and procedures are designed to monitor interest rates, NYMEX and over-the-counter positions, as well as physical volumes, grades, locations and delivery schedules to help ensure that our hedging activities address our market risks. We have a risk management group that has direct oversight responsibilities for our risk policies and our trading controls and procedures and certain aspects of risk management. Our risk management group also approves all new risk management strategies through a formal process.

Commodity Price Risk

We are exposed to commodity price risk with respect to our product inventories and related firm commitments to purchase and/or sell such inventories. We utilize NYMEX futures contracts to manage our exposure to changes in the fair value of our product inventories and related firm commitments. Derivative instruments designated and qualifying as fair value hedges under Statement No. 133 are recorded in the consolidated balance sheet as assets or liabilities at fair value with mark-to-market adjustments recorded in Cost of product sales. The offsetting gain or loss on the associated hedged physical inventory is recognized concurrently in Cost of product sales. During the three months ended March 31, 2008, we recorded a $0.8 million loss representing the change in fair value of inventories and firm commitments designated as the hedged item in qualifying fair value hedge relationships resulting in a loss of

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

$0.5 million due to the ineffectiveness of our fair value hedges. The ineffectiveness is recorded in Cost of product sales in the consolidated statements of income. No component of the associated derivative instruments gains or losses was excluded from our assessment of hedge ineffectiveness.

We record derivative instruments that do not qualify for hedge accounting under Statement No. 133 in the consolidated balance sheet as assets or liabilities at fair value with mark-to-market adjustments recorded in Cost of product sales.

On a limited basis, we also enter into derivative commodity instruments based on our analysis of market conditions in order to profit from market fluctuations. These derivative instruments are financial positions entered into without underlying physical inventory and are not considered hedges. We record these derivatives in the consolidated balance sheet as assets or liabilities at fair value with mark-to-market adjustments recorded in Product sales.

The earnings impact of our derivative activity was as follows:

	Three Months Ended March 31, 2008		
	Mark-to - market, net	Settled	Total
	(Thousands of Dollars)		
Commodity price-risk hedging loss	$ (2,423)	$ (3,490)	$ (5,913)
Trading gain (loss)	(896)	254	(642)
Total	$ (3,319)	$ (3,236)	$ (6,555)

Prior to the third quarter of 2007, we had not entered into any commodity derivatives with earnings impact.

Interest Rate Swaps

We are a party to certain interest rate swap agreements for the purpose of hedging the interest rate risk associated with a portion of our fixed-rate senior notes. We account for the interest rate swaps as fair value hedges and recognize the fair value of each interest rate swap in the consolidated balance sheet as either an asset or liability. The interest rate swap contracts qualify for the shortcut method of accounting prescribed by Statement No. 133. As a result, changes in the fair value of the derivatives will completely offset the changes in the fair value of the underlying hedged debt. As of March 31, 2008, the weighted-average interest rate for our interest rate swaps was 4.0%.

Concentration of Credit Risk

We are exposed to credit risk on our hedging instruments in the event of nonperformance by counterparties. However, because our hedging activities are transacted only with highly rated institutions, we do not anticipate nonperformance by any of these counterparties.

9. OTHER INCOME

Other income, net consisted of the following:

Three Months Ended March 31,

	2008	2007
	(Thousands of Dollars)	
Sale or disposal of fixed assets	$ 4,250	$ 1,316
Business interruption insurance	3,504	
Foreign exchange gains (losses)	1,813	(401)
Legal settlements		5,508
Other	342	200
Other income, net	$ 9,909	$ 6,623

The business interruption insurance amount consists of insurance proceeds related to lost earnings at our pipelines and terminals that serve Valero Energy Corporation s McKee refinery, which experienced a fire in February 2007.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

10. RELATED PARTY TRANSACTIONS

Our operations are managed by the general partner of our general partner, NuStar GP, LLC. The employees of NuStar GP, LLC perform services for our U.S. operations as well as for NuStar GP Holdings, LLC, the parent of NuStar GP, LLC. Certain of our wholly owned subsidiaries employ persons who perform services for our international operations. We reimburse NuStar GP, LLC for our portion of costs related to its employees. We had a payable of $0.8 million as of March 31, 2008 to NuStar GP, LLC and a receivable of $0.8 million as of December 31, 2007 from NuStar GP, LLC, with both amounts representing payroll and benefit plan costs, net of payments made by us. We also had a long-term payable as of March 31, 2008 and December 31, 2007 of $5.7 million to NuStar GP, LLC related to amounts payable for retiree medical benefits and other post-employment benefits.

The following table summarizes information pertaining to related party transactions with NuStar GP, LLC:

	Three Months Ended March 31,	
	2008	2007
	(Thousands of Dollars)	
Operating expenses	$ 24,321	$ 21,333
General and administrative expenses	9,822	9,806

GP Services Agreement

On April 24, 2008, the boards of directors of each NuStar GP, LLC and NuStar GP Holdings approved (i) the termination of the administration agreement, dated July 16, 2006, between NuStar GP Holdings and NuStar GP, LLC (the Administration Agreement) and (ii) the adoption of a services agreement between NuStar GP, LLC and NuStar Energy (the GP Services Agreement). All employees providing services to both NuStar GP Holdings and NuStar Energy are employed by NuStar GP, LLC.

Under the Administration Agreement, NuStar GP Holdings paid annual charges of $500,000 to NuStar GP, LLC in return for NuStar GP, LLC s provision of all executive management, accounting, legal, cash management, corporate finance and other administrative services to NuStar GP Holdings. NuStar GP Holdings also reimbursed NuStar GP, LLC for all direct public company costs and any other direct costs, such as outside legal and accounting fees, that NuStar GP, LLC incurred while providing services to NuStar GP Holdings pursuant to the Administration Agreement.

In connection with the termination of the Administration Agreement, NuStar Energy and NuStar GP, LLC entered into the GP Services Agreement, effective as of January 1, 2008. The GP Services Agreement provides that NuStar GP, LLC will furnish all services necessary for the conduct of the business of NuStar Energy and NuStar Energy will reimburse NuStar GP, LLC for all costs, other than the expenses allocated to NuStar GP Holdings (the Holdco Administrative Services Expense).

For the fiscal year 2008, the Holdco Administrative Services Expense will be equal to $750,000, plus 1.0% of NuStar GP, LLC s domestic bonus and unit compensation expense for the 2008 fiscal year. For the 2009 fiscal year and each fiscal year thereafter, the Holdco Administrative Services Expense will be $1.1 million (as adjusted), plus 1.0% of NuStar GP, LLC s domestic bonus and unit compensation expense. The Holdco Administrative Services Expense is subject to adjustment (a) by an annual amount equal to NuStar GP, LLC s annual merit increase percentage for the most recently completed contract year and (b) for changed levels of services due to expansion of operations through, among other things, expansion of operations, acquisitions or the construction of new businesses or assets.

The GP Services Agreement will terminate on December 31, 2012, with automatic two-year renewals unless terminated by either party upon six months prior written notice.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. PARTNERS EQUITY

Equity Offering

On April 2, 2008, we issued 4,450,000 common units representing limited partner interests at a price of $48.75 per unit. On April 7, 2008, the underwriters exercised their thirty-day option to purchase up to 667,500 common units and acquired an additional 600,800 common units at a price of $48.75 per unit. We received proceeds of $236.2 million, net of issuance costs, and a contribution of $5.0 million from our general partner to maintain its 2% general partner interest. The proceeds were used to repay the $124.0 million balance under our Term Loan Agreement and a portion of the outstanding principal balance under our 2007 Revolving Credit Agreement.

Allocation of Income and Income Per Unit

Our partnership agreement, as amended, sets forth the calculation to be used to determine the amount and priority of cash distributions that the common unitholders and general partner will receive. The partnership agreement also contains provisions for the allocation of net income and loss to the unitholders and the general partner. For purposes of maintaining partner capital accounts, the partnership agreement specifies that items of income and loss shall be allocated among the partners in accordance with their respective percentage interests. Normal allocations according to percentage interests are done after giving effect, if any, to priority income allocations in an amount equal to incentive cash distributions allocated 100% to the general partner.

We identified our general partner interest as participating securities and we use the two-class method when calculating Net income per unit applicable to limited partners, which is based on the weighted-average number of common units outstanding during the period. Basic and diluted net income per unit applicable to limited partners are the same because we have no potentially dilutive securities outstanding.

The following table details the calculation of net income applicable to the general partner:

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
	(Thousands of Dollars)	
Net income applicable to general partner and limited partners interest	$ 55,869	$ 31,123
Less general partner incentive distribution	5,188	3,910
Net income after general partner incentive distribution	50,681	27,213
General partner interest	2%	2%
General partner allocation of net income after general partner incentive distribution	1,014	544
General partner incentive distribution	5,188	3,910
Net income applicable to general partner	$ 6,202	$ 4,454

Cash Distributions

On January 24, 2008, we declared a quarterly cash distribution of $0.985 per unit which was paid on February 14, 2008 to unitholders of record on February 7, 2008. This distribution related to the fourth quarter of 2007 and totaled $55.0 million. On April 22, 2008, we declared a quarterly cash distribution of $0.985 per unit related to the first quarter of 2008. This distribution will be paid on May 14, 2008 to unitholders of record on May 7, 2008 and will total $60.6 million.

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table reflects the allocation of total cash distributions to the general and limited partners applicable to the period in which the distributions were earned:

	Three Months Ended March 31, 2008 (a)	Three Months Ended March 31, 2007
	(Thousands of Dollars)	
General partner interest	$ 1,211	$ 954
General partner incentive distribution	5,718	3,910
Total general partner distribution	6,929	4,864
Limited partners distribution	53,644	42,831
Total cash distributions	$ 60,573	$ 47,695
Cash distributions per unit applicable to limited partners	$ 0.985	$ 0.915

(a) Our net income allocation to general and limited partners reflected a total cash distribution based on the partnership interests outstanding as of March 31, 2008. We issued approximately 5.1 million common units in April 2008. Actual distribution payments are made within 45 days after the end of each quarter as of a record date that is set after the end of each quarter. As such, the general partner s portion of the actual distribution to be made with respect to the first quarter 2008, including the incentive distribution rights, will be greater than the net income allocation to the general partner.

Comprehensive Income

For the three months ended March 31, 2008 and 2007, the difference between our net income and our comprehensive income resulted from foreign currency translation adjustments. Our total comprehensive income was as follows:

	Three Months Ended March 31, 2008	Three Months Ended March 31, 2007
	(Thousands of Dollars)	
Net income	$ 55,869	$ 31,123
Foreign currency translation adjustment	(3,280)	1,010
Comprehensive income	$ 52,589	$ 32,133

12. STATEMENTS OF CASH FLOWS

Changes in current assets and current liabilities are as follows:

	Three Months Ended March 31, 2008	2007
	(Thousands of Dollars)	
Decrease (increase) in current assets:		
Accounts receivable	$ (71,295)	$ 11,673
Receivable from related party	786	
Inventories	(15,342)	9,542
Other current assets	(24,220)	(8,753)
Increase (decrease) in current liabilities:		
Accounts payable	33,494	(3,178)
Payable to related party	753	3,759
Accrued interest payable	(6,689)	(6,882)
Accrued liabilities	(4,317)	401
Taxes other than income taxes	2,064	(112)
Income taxes payable	1,384	(1,162)
Changes in current assets and current liabilities	$ (83,382)	$ 5,288

NUSTAR ENERGY L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash flows related to interest and income taxes were as follows:

	Three Months Ended March 31,	
	2008	2007
	(Thousands of Dollars)	
Cash paid for interest, net of amount capitalized	$ 28,195	$ 27,412
Cash paid for income taxes, net of tax refunds received	$ 1,986	$ 3,881

Non-cash investing and financing activities for the three months ended March 31, 2008 included:

- adjustments to property, plant and equipment, inventory and certain current and noncurrent assets and liabilities resulting from a preliminary purchase price allocation related to the East Coast Asphalt Operations acquisition.
- the recognition of a $5.1 million note payable and related other current asset pertaining to insurance.

Non-cash investing and financing activities for the three months ended March 31, 2007 included:

- adjustments to property, plant and equipment, goodwill and intangible assets resulting from adjustments to the purchase price allocations related to the St. James crude oil storage facility acquisition.
- the recognition of a $7.4 million note payable and related other current asset pertaining to insurance.

13. SEGMENT INFORMATION

Our operating segments consist of refined product terminals, refined product pipelines, crude oil pipelines, crude oil storage tanks and refining and marketing. These reportable segments are strategic business units that offer different services and performance is evaluated based on operating income, before general and administrative expenses. General and administrative expenses are not allocated to the operating segments since those expenses relate primarily to the overall management at the entity level. Our principal services include pipeline transportation services, terminalling services, storage lease services, crude oil storage handling services, and asphalt refining and marketing. Product sales included in our refining and marketing segment consist of sales of asphalt and other petroleum products to third parties.

During the fourth quarter of 2007, we revised the manner in which we internally evaluate our segment performance and made certain organizational changes. As a result, we changed the way we report our segmental information such that all product sales and related costs and assets are included in the refining and marketing segment. Previous periods have been restated to conform to this presentation.

Results of operations for the reportable segments were as follows:

	Three Months Ended March 31,	
	2008	2007
	(Thousands of Dollars)	
Revenues:		
Refined product terminals:		
Third party revenues	$ 92,601	$ 83,767
Intersegment revenues	4,605	