NuStar Energy L.P.
Form 10-Q
November 07, 2011

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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 September 30, 2011

OR

o 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	74-2956831
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)
2330 North Loop 1604 West San Antonio, Texas	78248
(Address of principal executive offices)	(Zip Code)

Registrant's telephone number, including area code (210) 918-2000

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 o

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No o

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:

Large accelerated filer	x	Accelerated filer	£
Non-accelerated filer	o (Do not check if a smaller reporting company)	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 o No x

The number of common units outstanding as of October 31, 2011 was 64,718,578.

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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)

	September 30, 2011 (Unaudited)	December 31, 2010
Assets		
Current assets:		
Cash and cash equivalents	$59,214	$181,121
Accounts receivable, net of allowance for doubtful accounts of $1,742 and $1,457 as of September 30, 2011 and December 31, 2010, respectively	467,912	302,053
Inventories	603,683	413,537
Other current assets	69,101	42,796
Total current assets	1,199,910	939,507
Property, plant and equipment, at cost	4,328,975	4,021,319
Accumulated depreciation and amortization	(943,539)	(833,862)
Property, plant and equipment, net	3,385,436	3,187,457
Intangible assets, net	42,499	43,033
Goodwill	846,526	813,270
Investment in joint venture	67,203	69,603
Deferred income tax asset	9,671	8,138
Other long-term assets, net	296,903	325,385
Total assets	$5,848,148	$5,386,393
Liabilities and Partners’ Equity		
Current liabilities:		
Current portion of long-term debt	$355,645	$832
Accounts payable	461,038	282,382
Payable to related party	12,369	10,345
Accrued interest payable	23,615	29,706
Accrued liabilities	110,934	57,953
Taxes other than income tax	16,499	10,718
Income tax payable	2,959	1,293
Total current liabilities	983,059	393,229
Long-term debt, less current portion	2,170,010	2,136,248
Long-term payable to related party	11,871	10,088
Deferred income tax liability	35,917	29,565
Other long-term liabilities	122,242	114,563
Commitments and contingencies (Note 5)		
Partners’ equity:		
Limited partners (64,670,520 and 64,610,549 common units outstanding as of September 30, 2011 and December 31, 2010, respectively)	2,553,995	2,598,873
General partner	56,284	57,327
Accumulated other comprehensive (loss) income	(97,912)	46,500
Total NuStar Energy L.P. partners' equity	2,512,367	2,702,700

Noncontrolling interest	12,682	—
Total partners’ equity	2,525,049	2,702,700
Total liabilities and partners’ equity	$5,848,148	$5,386,393

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 September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
Revenues:				
Service revenues:				
Third parties	$210,395	$201,390	$607,866	$585,772
Related party	286	—	823	—
Total service revenues	210,681	201,390	608,689	585,772
Product sales	1,613,669	936,989	4,039,461	2,623,077
Total revenues	1,824,350	1,138,379	4,648,150	3,208,849
Costs and expenses:				
Cost of product sales	1,535,609	860,942	3,797,424	2,422,751
Operating expenses:				
Third parties	98,464	86,104	281,419	259,465
Related party	37,151	35,644	109,061	103,563
Total operating expenses	135,615	121,748	390,480	363,028
General and administrative expenses:				
Third parties	8,746	9,727	27,865	28,633
Related party	8,985	17,133	41,968	47,691
Total general and administrative expenses	17,731	26,860	69,833	76,324
Depreciation and amortization expense	42,418	38,539	124,354	114,653
Total costs and expenses	1,731,373	1,048,089	4,382,091	2,976,756
Operating income	92,977	90,290	266,059	232,093
Equity in earnings of joint venture	2,599	2,454	6,997	7,571
Interest expense, net	(21,565)	(20,583)	(62,644)	(58,059)
Other income (expense), net	767	(235)	(5,699)	14,882
Income before income tax expense	74,778	71,926	204,713	196,487
Income tax expense	4,497	3,616	13,311	9,052
Net income	70,281	68,310	191,402	187,435
Less net income attributable to noncontrolling interest	123	—	143	—
Net income attributable to NuStar Energy L.P.	$70,158	$68,310	$191,259	$187,435
Net income per unit applicable to limited partners (Note 11)	$0.92	$0.90	$2.49	$2.55
Weighted-average limited partner units outstanding	64,612,423	64,610,549	64,611,181	62,386,373

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)

	Nine Months Ended September 30,	
	2011	2010
Cash Flows from Operating Activities:		
Net income	$191,402	$187,435
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	124,354	114,653
Amortization of debt related items	(8,328)	(5,812)
Gain on sale or disposition of assets, including insurance recoveries	(117)	(12,926)
Deferred income tax expense (benefit)	4,130	(1,932)
Equity in earnings of joint venture	(6,997)	(7,571)
Distributions of equity in earnings of joint venture	9,397	7,500
Changes in current assets and current liabilities (Note 12)	(216,427)	(99,815)
Other, net	4,457	(699)
Net cash provided by operating activities	101,871	180,833
Cash Flows from Investing Activities:		
Reliability capital expenditures	(32,808)	(34,927)
Strategic capital expenditures	(211,150)	(156,531)
Acquisitions	(100,693)	(43,026)
Proceeds from insurance recoveries	—	13,500
Investment in other long-term assets	(8,449)	(3,400)
Proceeds from sale or disposition of assets	445	1,992
Net cash used in investing activities	(352,655)	(222,392)
Cash Flows from Financing Activities:		
Proceeds from long-term debt borrowings	707,102	775,434
Proceeds from short-term debt borrowings	31,600	177,041
Proceeds from senior note offering, net of issuance costs	—	445,574
Long-term debt repayments	(348,153)	(1,146,183)
Short-term debt repayments	(31,600)	(197,041)
Proceeds from issuance of common units, net of issuance costs	1,583	240,158
Contributions from general partner	70	5,078
Distributions to unitholders and general partner	(240,571)	(225,538)
Proceeds from termination of interest rate swaps	12,632	—
Other, net	(785)	(8,746)
Net cash provided by financing activities	131,878	65,777
Effect of foreign exchange rate changes on cash	(3,001)	(358)
Net (decrease) increase in cash and cash equivalents	(121,907)	23,860
Cash and cash equivalents as of the beginning of the period	181,121	62,006
Cash and cash equivalents as of the end of the period	$59,214	$85,866

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 AND BASIS OF PRESENTATION

Organization
NuStar Energy L.P. (NuStar Energy) (NYSE: NS) is engaged in the terminalling and storage of petroleum products, the transportation of petroleum products and anhydrous ammonia, and petroleum refining and marketing. Unless otherwise indicated, the terms "NuStar Energy," "the Partnership," "we," "our" and "us" are used in this report to refer to NuSt Energy L.P., to one or more of our consolidated subsidiaries or to all of them taken as a whole. NuStar GP Holdings, LLC (NuStar GP Holdings) (NYSE: NSH) owns our general partner, Riverwalk Logistics, L.P., and owns a 17.6% total interest in us as of September 30, 2011.
We conduct our operations through our subsidiaries, primarily NuStar Logistics, L.P. (NuStar Logistics) and NuStar Pipeline Operating Partnership L.P. (NuPOP). We have three business segments: storage, transportation, and asphalt and fuels marketing.
Basis of Presentation
These unaudited consolidated financial statements include the accounts of the Partnership and subsidiaries in which the Partnership has a controlling interest. Noncontrolling interests are separately disclosed on the consolidated balance sheets and consolidated statements of income. Intercompany balances and transactions have been eliminated in consolidation. We account for investments in 50% or less-owned entities using the equity method.
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 the Quarterly Report on 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, and all disclosures are adequate. All such adjustments are of a normal recurring nature unless disclosed otherwise. Financial information for the three and nine months ended September 30, 2011 and 2010 included in these Condensed Notes to Consolidated Financial Statements is derived from our unaudited consolidated financial statements. Operating results for the three and nine months ended September 30, 2011 are not necessarily indicative of the results that may be expected for the year ending December 31, 2011. The consolidated balance sheet as of December 31, 2010 has been derived from the audited consolidated financial statements as of that date. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2010.

Reclassifications
Certain previously reported amounts in the 2010 consolidated financial statements have been reclassified to conform to the 2011 presentation.

Acquisitions
On April 19, 2011, we purchased certain refining and storage assets, inventory and other working capital items from AGE Refining, Inc. for $62.0 million, including the assumption of certain environmental liabilities. The assets consist of a 14,500 barrel per day refinery in San Antonio, Texas (the San Antonio Refinery) and 200,000 barrels of storage capacity in Elmendorf, Texas. 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 consolidated statements of income include the results of operations for our acquisition of the San Antonio Refinery and related storage assets commencing on April 19, 2011.

On February 9, 2011, we acquired 75% of the outstanding capital of a Turkish company, which owns two terminals in Mersin, Turkey, with an aggregate 1.3 million barrels of storage capacity, for approximately $57.3 million (the Turkey Acquisition). Both terminals are connected via pipelines to an offshore platform located approximately three miles off the Mediterranean Sea coast. The purchase price has been preliminarily allocated based on the estimated fair values of the individual assets acquired, liabilities assumed and noncontrolling interest at the date of acquisition. The purchase price allocation is pending completion of an independent appraisal and other evaluations. The consolidated statements of income include the results of operations for the Turkey Acquisition commencing on February 9, 2011, with 25% accounted for as a noncontrolling interest.

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2. NEW ACCOUNTING PRONOUNCEMENTS

Goodwill Impairment

In September 2011, the Financial Accounting Standards Board (FASB) amended the goodwill impairment guidance to simplify testing goodwill for impairment. The amended guidance provides entities an option to first assess qualitative factors to determine whether it is necessary to perform the two-step quantitative goodwill impairment test. Under that option, an entity would not be required to calculate the fair value of a reporting unit unless the entity determines, based on that qualitative assessment, that it is more likely than not that its fair value is less than its carrying amount. The amended guidance is effective for annual and interim goodwill impairment tests performed for fiscal years beginning after December 15, 2011, and early adoption is permitted. We are evaluating whether to adopt the amended guidance for the 2011 goodwill impairment test performed in the fourth quarter, but we do not expect the amended guidance to have a material impact on our financial position or results of operations.

Other Comprehensive Income

In June 2011, the FASB amended the disclosure requirements for the presentation of comprehensive income. The amended requirements eliminate the option to present components of other comprehensive income (OCI) as part of the statement of changes in equity. Under the amended requirements, all changes in OCI are to be presented either in a single continuous statement of comprehensive income or in two separate but consecutive financial statements. In addition, entities will be required to disclose reclassification adjustments between other comprehensive income and net income separately on the face of the financial statements. The changes are effective for fiscal years and interim periods beginning after December 15, 2011, and retrospective application is required. Accordingly, we will adopt these provisions January 1, 2012. These amendments only affect financial statement presentation and will not have an impact on our financial position or results of operations.

Fair Value Measurements

In May 2011, the FASB issued amended guidance and disclosure requirements for fair value measurements. The new guidance results in a consistent definition of fair value and common requirements for measurement of and disclosure about fair value between GAAP and International Financial Reporting Standards. These changes are effective for interim and annual periods beginning on or after December 15, 2011, and early adoption is not permitted. Accordingly, we will adopt these provisions January 1, 2012, and we do not expect the amended guidance to have a material impact on our financial position, results of operations or disclosures.

3. INVENTORIES

Inventories consisted of the following:

	September 30, 2011	December 31, 2010
	(Thousands of Dollars)	
Crude oil	$220,672	$122,945
Finished products	372,841	281,197
Materials and supplies	10,170	9,395
Total	$603,683	$413,537

4. DEBT

Revolving Credit Agreement

During the nine months ended September 30, 2011, we borrowed an aggregate $615.0 million under our $1.2 billion five-year revolving credit agreement (the 2007 Revolving Credit Agreement) to fund a portion of our capital expenditures and working capital requirements. Additionally, we repaid $348.2 million during the nine months ended September 30, 2011. The 2007 Revolving Credit Agreement bears interest based on either an alternative base rate or a LIBOR-based rate. As of September 30, 2011, our weighted average borrowing interest rate was 0.9%, and we had $376.2 million available for borrowing under the 2007 Revolving Credit Agreement. Due to a covenant in our 2007 Revolving Credit Agreement that requires us to maintain, as of the end of any four consecutive fiscal quarters, a consolidated debt coverage ratio not to exceed 5.00-to-1.00, we may not be able to borrow the maximum available amount. On March 7, 2011, we amended the 2007 Revolving Credit Agreement to exclude unused proceeds from the Gulf Opportunity Zone bond issuances from total indebtedness in the calculation of the consolidated debt coverage ratio. As of September 30, 2011, our consolidated debt coverage ratio was 4.5x.

Gulf Opportunity Zone Revenue Bonds
The Parish of St. James, Louisiana issued, pursuant to the Gulf Opportunity Zone Act of 2005, three separate series of tax-exempt revenue bonds in 2010 and one series of tax-exempt revenue bonds in 2011 (GoZone Bonds) associated with our St. James terminal expansion. The $75.0 million of tax-exempt revenue bonds issued in 2011 mature on August 1, 2041. The interest rate on the GoZone Bonds is based on a weekly tax-exempt bond market interest rate, and interest is paid monthly. The interest rate was 0.2% as of September 30, 2011. Following the issuance, the proceeds were deposited with a trustee and will be disbursed to us upon our request for reimbursement of expenditures related to our St. James terminal expansion. The amount remaining in trust related to the GoZone Bonds is included in “Other long-term assets, net,” and the amount of bonds issued is included in “Long-term debt, less current portion” in our consolidated balance sheets. For the nine months ended September 30, 2011, $92.1 million was disbursed from the trustee. As of September 30, 2011, the amount remaining in trust totaled $187.6 million.

Lines of Credit
As of September 30, 2011, we had one short-term line of credit with an uncommitted borrowing capacity of up to $20.0 million. We had no outstanding borrowings on this line of credit as of September 30, 2011. During the nine months ended September 30, 2011, we borrowed and repaid $31.6 million related to this line of credit.

5. COMMITMENTS AND CONTINGENCIES

Contingencies
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 September 30, 2011, we have accrued $76.5 million for contingent losses. The amount that will ultimately be paid related to these matters may differ from the amounts accrued, and the timing of such payments is uncertain.

Grace Energy Corporation Matter. In 1997, Grace Energy Corporation (Grace Energy) sued subsidiaries of Kaneb Pipeline Partners, L.P. (KPP) and Kaneb Services LLC (KSL and collectively with KPP and their respective subsidiaries, Kaneb) in Texas state court. We acquired Kaneb on July 1, 2005. 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. In September 2008, Grace Energy filed its Joint Plan of Reorganization and Disclosure Statement.

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 United States 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 plumes. In November 2008, the DOJ forwarded information to us indicating that the past and estimated future remediation expenses associated with one plume are $71.9 million. The DOJ has indicated that they will not seek recovery of remediation costs for the second plume. 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. We are currently in settlement discussions with other potentially responsible parties and the DOJ, and a change in our estimate of this liability may occur in the near term. However, the proposed settlement must be approved by multiple parties and requires the approval of the bankruptcy court and the federal district court. We estimate that a settlement may be finalized in early to mid-2012.

Eres Matter. In August 2008, Eres N.V. (Eres) forwarded a demand for arbitration to CITGO Asphalt Refining Company (CARCO), CITGO Petroleum Corporation (CITGO), NuStar Asphalt Refining, LLC (NuStar Asphalt) and NuStar Marketing LLC (NuStar Marketing, and together with CARCO, CITGO and NuStar Asphalt, the Defendants) contending that the Defendants breached a tanker voyage charter party agreement, dated November 2004, between Eres and CARCO (the Charter Agreement). The Charter Agreement provided for CARCO's use of Eres' vessels for the shipment of asphalt. Eres contended that NuStar Asphalt and/or NuStar Marketing (together, the NuStar Entities) assumed the Charter Agreement when NuStar Asphalt purchased the CARCO assets, and that the Defendants had failed to perform under the Charter Agreement. Eres valued its damages for the alleged breach of contract claim at approximately $78.1 million. On October 14, 2011, Eres and the Defendants entered into a Settlement Agreement and Mutual Release. Pursuant to the terms of the Settlement Agreement and Mutual Release, the NuStar Entities paid $33.5 million in full and final settlement of all of Eres' claims against the Defendants. The settlement amount was included in the accrual for contingent losses as of September 30, 2011.

Other. We are also a party to additional claims and legal proceedings arising in the ordinary course of business. 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. It is possible that if one or more of the matters described above were decided against us, the effects could be material to our results of operations in the period in which we would be required to record or adjust the related liability and could also be material to our cash flows in the periods we would be required to pay such liability.

6. FAIR VALUE MEASUREMENTS

We segregate 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. We consider counterparty credit risk and our own credit risk in the determination of all estimated fair values.

Product Imbalances
We value our assets and liabilities related to product imbalances using quoted market prices as of the reporting date.

Interest Rate Swaps
We estimate the fair value of both our fixed-to-floating and forward-starting interest rate swaps using discounted cash flows, which use observable inputs such as time to maturity and market interest rates.

Commodity Derivatives
The fair value of certain of our commodity derivative instruments are based on quoted prices on an exchange; accordingly, these are categorized in Level 1 of the fair value hierarchy. We also have derivative instruments that are are valued using industry pricing services and other observable inputs, such as quoted prices on an exchange for similar derivative instruments. Therefore, these derivative instruments are categorized in Level 2 of the fair value hierarchy. We have consistently applied these valuation techniques in all periods presented. See Note 7. Derivatives and Risk Management Activities for a discussion of our derivative instruments.

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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:

	September 30, 2011			
	Level 1	Level 2	Level 3	Total
	(Thousands of Dollars)			
Other current assets:				
Product imbalances	$1,903	$—	$—	$1,903
Commodity derivatives	22,534	—	—	22,534
Other long-term assets, net:				
Interest rate swaps	—	23,125	—	23,125
Accrued liabilities:				
Product imbalances	(1,069)	—	—	(1,069)
Commodity derivatives	(8,265)	(50,433)	—	(58,698)
Interest rate swaps	—	(18,624)	—	(18,624)
Other long-term liabilities:				
Interest rate swaps	—	(22,306)	—	(22,306)
Total	$15,103	$(68,238)	$—	$(53,135)

	December 31, 2010			
	Level 1	Level 2	Level 3	Total
	(Thousands of Dollars)			
Other current assets:				
Product imbalances	$991	$—	$—	$991
Other long-term assets, net:				
Interest rate swaps	—	45,663	—	45,663
Accrued liabilities:				
Product imbalances	(988)	—	—	(988)
Commodity derivatives	(14,741)	—	—	(14,741)
Other long-term liabilities:				
Interest rate swaps	—	(29,483)	—	(29,483)
Total	$(14,738)	$16,180	$—	$1,442

Fair Value of Financial Instruments

We do not record our outstanding debt at fair value in our consolidated balance sheet. The estimated fair value and carrying amount of our debt was as follows:

	September 30, 2011	December 31, 2010
	(Thousands of Dollars)	
Fair value	$2,595,533	$2,249,190
Carrying amount	$2,525,655	$2,137,080

We estimated the fair values of our debt using a discounted cash flow analysis using current incremental borrowing rates for similar types of borrowing arrangements.

7. DERIVATIVES 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, futures and swaps 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 committee that oversees our trading controls and procedures and certain aspects of commodity and trading risk management. Our risk management committee also reviews all new commodity and trading risk management strategies in accordance with our risk management policy, as approved by our board of directors.

Interest Rate Risk

We are a party to certain interest rate swap agreements to manage our exposure to changes in interest rates. We have fixed-to-floating interest rate swap agreements associated with a portion of our fixed-rate senior notes. We account for our fixed-to-floating interest rate swaps as fair value hedges. During the nine months ended September 30, 2011, we entered into and terminated a fixed-to-floating interest rate swap agreement with a notional amount of $40.0 million related to the 7.65% senior notes issued in April 2008. We also terminated interest rate swap agreements with an aggregate notional amount of $167.5 million associated with our 6.875% and 6.05% senior notes during the nine months ended September 30, 2011. We received $12.6 million in connection with the terminations, which is being amortized into "Interest expense, net" over the remaining lives of the 7.65%, 6.875% and 6.05% senior notes. Proceeds from the termination of interest rate swap agreements are included in cash flows from financing activities on the consolidated statements of cash flows.

The total aggregate notional amount of the fixed-to-floating interest rate swaps was $450.0 million as of September 30, 2011 and $617.5 million as of December 31, 2010. The weighted-average interest rate that we paid under our fixed-to-floating interest rate swaps was 2.6% as of September 30, 2011.

We are also a party to forward-starting interest rate swap agreements with an aggregate notional amount of $500.0 million as of September 30, 2011 and December 31, 2010 related to forecasted probable debt issuances in 2012 and 2013. We entered into the swaps in order to hedge the risk of changes in the interest payments attributable to changes in the benchmark interest rate during the period from the effective date of the swap to the issuance of the forecasted debt. These swaps are designated and qualify as cash flow hedges.

Commodity Price Risk

We are exposed to market risks related to the volatility of crude oil and refined product prices. In order to reduce the risk of commodity price fluctuations with respect to our crude oil and finished product inventories and related firm commitments to purchase and/or sell such inventories, we utilize commodity futures and swap contracts, which qualify and we designate as fair value hedges.

During the second quarter of 2011, we entered into commodity swap contracts to hedge the price risk associated with the San Antonio Refinery. These contracts fix the purchase price of crude oil and sales prices of refined products for a portion of the expected production of the San Antonio Refinery, thereby attempting to mitigate the risk of volatility of future cash flows associated with hedged volumes. These contracts qualified and we designated them as cash flow hedges.

Derivatives that are intended to hedge our commodity price risk, but fail to qualify as fair value or cash flow hedges, are considered economic hedges, and associated gains and losses are recorded in net income. We also enter into commodity derivatives in order to attempt to profit from market fluctuations. These derivative instruments are financial positions entered into without underlying physical inventory and are not considered hedges. Changes in the fair values are recorded in net income.

The volume of commodity contracts is based on open derivative positions and represents the combined volume of our long and short positions on an absolute basis, which totaled 31.2 million barrels and 12.8 million barrels as of September 30, 2011 and December 31, 2010, respectively.

As of December 31, 2010, we had $17.8 million of margin deposits related to our derivative instruments and none as of September 30, 2011.

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The fair values of our derivative instruments included in our consolidated balance sheets were as follows:

	Balance Sheet Location	Asset Derivatives September 30, 2011	December 31, 2010	Liability Derivatives September 30, 2011	December 31, 2010
		(Thousands of Dollars)			
Derivatives Designated as Hedging Instruments:					
Commodity contracts	Other current assets	$3,072	$—	$(72)	$—
Interest rate swaps	Other long-term assets, net	23,125	45,663	—	—
Commodity contracts	Accrued liabilities	196,026	2,176	(246,459)	(2,522)
Interest rate swaps	Accrued liabilities	—	—	(18,624)	—
Interest rate swaps	Other long-term liabilities	—	—	(22,306)	(29,483)
Total		222,223	47,839	(287,461)	(32,005)
Derivatives Not Designated as Hedging Instruments:					
Commodity contracts	Other current assets	38,774	—	(19,240)	—
Commodity contracts	Accrued liabilities	10,826	46,632	(19,091)	(61,027)
Total		49,600	46,632	(38,331)	(61,027)
Total Derivatives		$271,823	$94,471	$(325,792)	$(93,032)

The earnings impact of our derivative activity was as follows:

Derivatives Designated as Fair Value Hedging Instruments	Income Statement Location	Amount of Gain (Loss) Recognized in Income on Derivative (Effective Portion)	Amount of Gain (Loss) Recognized in Income on Hedged Item	Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective Portion)
		(Thousands of Dollars)		
Three months ended September 30, 2011:				
Interest rate swaps	Interest expense, net	$45,963	$(46,320)	$ (357)
Commodity contracts	Cost of product sales	3,772	(4,508)	(736)
Total		$49,735	$(50,828)	$ (1,093)
Three months ended September 30, 2010:				
Interest rate swaps	Interest expense, net	$3,886	$(3,886)	$ —
Commodity contracts	Cost of product sales	(6,773)	12,297	5,524
Total		$(2,887)	$8,411	$ 5,524

Nine months ended September 30, 2011:				
Interest rate swaps	Interest expense, net	$54,577	$(55,172)	$ (595)
Commodity contracts	Cost of product sales	(7,292)	6,212	(1,080)
Total		$47,285	$(48,960)	$ (1,675)
Nine months ended September 30, 2010:				
Interest rate swaps	Interest expense, net	$7,010	$(7,010)	$ —
Commodity contracts	Cost of product sales	4,961	3,382	8,343
Total		$11,971	$(3,628)	$ 8,343

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Derivatives Designated as Cash Flow Hedging Instruments	Amount of Gain (Loss) Recognized in OCI on Derivative (Effective Portion)	Income Statement Location (a)	Amount of Gain (Loss) Reclassified from Accumulated OCI into Income (Effective Portion)	Amount of Gain (Loss) Recognized in Income on Derivative (Ineffective Portion)
	(Thousands of Dollars)		(Thousands of Dollars)	
Three months ended September 30, 2011:				
Interest rate swaps	$ (63,100)	Interest expense, net	$—	$ —
Commodity contracts	(46,532)	Cost of product sales	(7,733)	3,594
Total	$ (109,632)		$(7,733)	$ 3,594
Three months ended September 30, 2010:				
Interest rate swaps	$ (1,790)	Interest expense, net	$—	$ —
Commodity contracts	(1,326)	Cost of product sales	—	(284)
Total	$ (3,116)		$—	$ (284)
Nine months ended September 30, 2011:				
Interest rate swaps	$ (75,930)	Interest expense, net	$—	$ —
Commodity contracts	(62,986)	Cost of product sales	(8,958)	3,594
Total	$ (138,916)		$(8,958)	$ 3,594
Nine months ended September 30, 2010:				
Interest rate swaps	$ (1,790)	Interest expense, net	$—	$ —
Commodity contracts	(1,087)	Cost of product sales	(913)	—
Total	$ (2,877)		$(913)	$ —

(a) Amounts are included in specified location for both the gain (loss) reclassified from accumulated other comprehensive income into income (effective portion) and the gain (loss) recognized in income on derivative (ineffective portion).

Derivatives Not Designated as Hedging Instruments	Income Statement Location	Amount of Gain (Loss) Recognized in Income (Thousands of Dollars)
Three months ended September 30, 2011:		
Commodity contracts	Cost of product sales	$5,482
Three months ended September 30, 2010:		
Commodity contracts	Cost of product sales	$(1,963)
Nine months ended September 30, 2011:		
Commodity contracts	Revenues	$235

Commodity contracts	Cost of product sales	(5,685	)
Commodity contracts	Operating expenses	46	
Total		$(5,404	)
Nine months ended September 30, 2010:			
Commodity contracts	Cost of product sales	$4,735	
Commodity contracts	Operating expenses	(10	)
Total		$4,725	

For derivatives designated as cash flow hedging instruments, once a hedged transaction occurs, we reclassify the effective portion from accumulated OCI to “Cost of product sales” or “Interest expense, net.” As of September 30, 2011, we expect to reclassify a loss of $25.0 million to “Cost of product sales” and a loss of $1.2 million to “Interest expense, net” within the next twelve months. The maximum length of time over which we are hedging our exposure to the variability in future cash flows is approximately two years for our forward-starting interest rate swaps and approximately four years for our commodity contracts.

8. RELATED PARTY TRANSACTIONS

Our operations are managed by NuStar GP, LLC, the general partner of our general partner. Under a services agreement between NuStar Energy and NuStar GP, LLC, employees of NuStar GP, LLC perform services for our U.S. operations. Certain of our wholly owned subsidiaries employ persons who perform services for our international operations. Employees of NuStar GP, LLC provide services to both NuStar Energy and NuStar GP Holdings; therefore, we reimburse NuStar GP, LLC for all costs related to its employees, other than costs associated with NuStar GP Holdings. Related party revenues result from storage agreements between our Turkey subsidiary and the noncontrolling shareholder.

The following table summarizes information pertaining to related party transactions:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Thousands of Dollars)			
Revenues	$286	$—	$823	$—
Operating expenses	$37,151	$35,644	$109,061	$103,563
General and administrative expenses	$8,985	$17,133	$41,968	$47,691

We had a payable to NuStar GP, LLC of $12.4 million and $10.3 million, as of September 30, 2011 and December 31, 2010, respectively, with both amounts representing payroll, employee benefit plans and unit-based compensation. We also had a long-term payable to NuStar GP, LLC as of September 30, 2011 and December 31, 2010 of $11.9 million and $10.1 million, respectively, related to amounts payable for retiree medical benefits and other post-employment benefits.

9. OTHER INCOME (EXPENSE)

Other income (expense), net consisted of the following:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Thousands of Dollars)			
Contingent loss adjustment	$(3,250)	$—	$(3,250)	$—
Storage agreement early termination costs	—	—	(5,000)	—
Gain from insurance recoveries	—	—	—	13,500

(Loss) gain from sale or disposition of assets	(119)	114	117	(574)
Foreign exchange gains (losses)	3,059	(333)	2,483	(567)
Other, net	1,077	(16)	(49)	2,523
Other income (expense), net	$767	$(235)	$(5,699)	$14,882

For the three and nine months ended September 30, 2011, the contingent loss adjustment relates to the Eres matter discussed in Note 5. Commitments and Contingencies. For the nine months ended September 30, 2011, "Other income (expense), net" included $5.0 million in costs associated with the early termination of a third-party storage agreement at our Paulsboro, New Jersey asphalt refinery. For the nine months ended September 30, 2010, the gain from insurance recoveries resulted from insurance claims related to damage in the third quarter of 2008 primarily at our Texas City, Texas terminal caused by Hurricane Ike.

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10. PARTNERS' EQUITY

Partners' Equity Activity
The following table summarizes changes in the carrying amount of partners' equity and noncontrolling interest:

	Three Months Ended September 30, 2011			Three Months Ended September 30, 2010		
	NuStar Energy L.P. Partners' Equity	Noncontrolling Interest	Total Partners' Equity	NuStar Energy L.P. Partners' Equity	Noncontrolling Interest	Total Partners' Equity
	(Thousands of Dollars)					
Beginning balance	$2,644,221	$ 14,745	$2,658,966	$2,694,908	$ —	$2,694,908
Net income	70,158	123	70,281	68,310	—	68,310
Other comprehensive income:						
Foreign currency translation adjustment	(22,165)	(2,186)	(24,351)	9,026	—	9,026
Unrealized gain (loss) on cash flow hedges	(109,632)	—	(109,632)	(3,116)	—	(3,116)
Net loss reclassified into income on cash flow hedges	7,733	—	7,733	—	—	—
Total other comprehensive (loss) income	(124,064)	(2,186)	(126,250)	5,910	—	5,910
Total comprehensive (loss) income	(53,906)	(2,063)	(55,969)	74,220	—	74,220
Cash distributions to partners	(81,339)	—	(81,339)	(78,754)	—	(78,754)
Issuance of common units, including contribution from general partner	3,391	—	3,391	(139)	—	(139)
Ending balance	$2,512,367	$ 12,682	$2,525,049	$2,690,235	$ —	$2,690,235

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	Nine Months Ended September 30, 2011			Nine Months Ended September 30, 2010		
	NuStar Energy L.P. Partners' Equity	Noncontrolling Interest	Total Partners' Equity	NuStar Energy L.P. Partners' Equity	Noncontrolling Interest	Total Partners' Equity
	(Thousands of Dollars)					
Beginning balance	$2,702,700	$—	$2,702,700	$2,484,968	$—	$2,484,968
Turkey acquisition	—	15,000	15,000	—		—
Net income	191,259	143	191,402	187,435	—	187,435
Other comprehensive income:						
Foreign currency translation adjustment	(14,454)	(2,461)	(16,915)	98	—	98
Unrealized gain (loss) on cash flow hedges	(138,916)	—	(138,916)	(2,877)	—	(2,877)
Net loss reclassified into income on cash flow hedges	8,958	—	8,958	913	—	913
Total other comprehensive (loss)	(144,412)	(2,461)	(146,873)	(1,866)	—	(1,866)
Total comprehensive income (loss)	46,847	(2,318)	44,529	185,569	—	185,569
Cash distributions to partners	(240,571)	—	(240,571)	(225,538)	—	(225,538)
Issuance of common units, including contribution from general partner	3,391	—	3,391	245,236	—	245,236
Ending balance	$2,512,367	$12,682	$2,525,049	$2,690,235	$—	$2,690,235

Allocations of Net Income

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 the 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 made after giving effect to priority income allocations, if any, in an amount equal to incentive cash distributions allocated 100% to the general partner. The following table details the calculation of net income applicable to the general partner:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Thousands of Dollars)			
Net income attributable to NuStar Energy L.P.	$70,158	$68,310	$191,259	$187,435
Less general partner incentive distribution	8,972	8,568	26,503	24,736
Net income after general partner incentive distribution	61,186	59,742	164,756	162,699

General partner interest	2 %	2 %	2 %	2 %
General partner allocation of net income after general partner incentive distribution	1,223	1,195	3,294	3,254
General partner incentive distribution	8,972	8,568	26,503	24,736
Net income applicable to general partner	$10,195	$9,763	$29,797	$27,990

Cash Distributions

On August 12, 2011, we paid a quarterly cash distribution totaling $81.3 million, or $1.095 per unit, related to the second quarter of 2011. On October 28, 2011, we announced a quarterly cash distribution of $1.095 per unit related to the third quarter of 2011. This distribution will be paid on November 14, 2011 to unitholders of record on November 8, 2011 and will total $81.4 million.

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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 September 30,		Nine Months Ended September 30,	
	2011	2010	2011	2010
	(Thousands of Dollars, Except Per Unit Data)			
General partner interest	$1,628	$1,592	$4,847	$4,635
General partner incentive distribution	8,972	8,568	26,503	24,736
Total general partner distribution	10,600	10,160	31,350	29,371
Limited partners’ distribution	70,814	69,456	211,019	202,391