

VALERO ENERGY CORP/TX

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)

**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 1-13175

VALERO ENERGY CORPORATION
(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

74-1828067
(I.R.S. Employer
Identification No.)

One Valero Way
San Antonio, Texas
(Address of principal executive offices)

78249

(Zip Code)

(210) 345-2000

(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 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 Rule 12b-2 of the Exchange Act.

Large accelerated filer Accelerated filer Non-accelerated filer 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

The number of shares of the registrant's only class of common stock, \$0.01 par value, outstanding as of April 30, 2008 was 528,503,332.

**VALERO ENERGY CORPORATION AND SUBSIDIARIES
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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED BALANCE SHEETS
(Millions of Dollars, Except Par Value)

	March 31, 2008 (Unaudited)	December 31, 2007
ASSETS		
Current assets:		
Cash and temporary cash investments	\$ 1,431	\$ 2,464
Restricted cash	41	31
Receivables, net	6,009	7,691
Inventories	4,643	4,184
Deferred income taxes	271	247
Prepaid expenses and other	119	175
 Total current assets	 12,514	 14,792
Property, plant and equipment, at cost	26,289	25,787
Accumulated depreciation	(4,305)	(4,078)
Property, plant and equipment, net	21,984	21,709
Intangible assets, net	275	290
Goodwill	4,060	4,061
Deferred charges and other assets, net	1,836	1,870
 Total assets	 \$ 40,669	 \$ 42,722
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	\$ 3	\$ 392
Accounts payable	8,635	9,596
Accrued expenses	490	502
Taxes other than income taxes	534	632
Income taxes payable	202	499
Deferred income taxes	293	293
 Total current liabilities	 10,157	 11,914
Long-term debt and capital lease obligations, less current portion	6,471	6,470
Deferred income taxes	4,008	4,021
Other long-term liabilities	1,801	1,810

Commitments and contingencies

Stockholders' equity:

Common stock, \$0.01 par value; 1,200,000,000 shares authorized; 627,501,593 and 627,501,593 shares issued	6	6
Additional paid-in capital	7,258	7,111
Treasury stock, at cost; 99,063,806 and 90,841,602 common shares	(6,574)	(6,097)
Retained earnings	17,110	16,914
Accumulated other comprehensive income	432	573
Total stockholders' equity	18,232	18,507
Total liabilities and stockholders' equity	\$ 40,669	\$ 42,722

See Condensed Notes to Consolidated Financial Statements.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF INCOME
(Millions of Dollars, Except per Share Amounts)
(Unaudited)

	Three Months Ended March	
	31,	
	2008	2007
Operating revenues (1)	\$ 27,945	\$ 18,755
Costs and expenses:		
Cost of sales	25,669	15,510
Refining operating expenses	1,114	934
Retail selling expenses	188	171
General and administrative expenses	135	145
Depreciation and amortization expense	367	322
Total costs and expenses	27,473	17,082
Operating income	472	1,673
Other income, net	20	5
Interest and debt expense:		
Incurred	(116)	(89)
Capitalized	19	31
Income from continuing operations before income tax expense	395	1,620
Income tax expense	134	532
Income from continuing operations	261	1,088
Income from discontinued operations, net of income tax expense	-	56
Net income	\$ 261	\$ 1,144
Earnings per common share:		
Continuing operations	\$ 0.49	\$ 1.82
Discontinued operations	-	0.09
Total	\$ 0.49	\$ 1.91
Weighted-average common shares outstanding (in millions)	532	599

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Earnings per common share assuming dilution:		
Continuing operations	\$ 0.48	\$ 1.77
Discontinued operations	-	0.09
Total	\$ 0.48	\$ 1.86
Weighted-average common shares outstanding assuming dilution (in millions)	541	615
Dividends per common share	\$ 0.12	\$ 0.12
Supplemental information:		
(1) Includes excise taxes on sales by our U.S. retail system	\$ 194	\$ 196
See Condensed Notes to Consolidated Financial Statements.		

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Millions of Dollars)
(Unaudited)

	Three Months Ended March	
	31,	
	2008	2007
Cash flows from operating activities:		
Net income	\$ 261	\$ 1,144
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	367	334
Stock-based compensation expense	12	30
Deferred income tax expense	8	44
Changes in current assets and current liabilities	(11)	338
Changes in deferred charges and credits and other operating activities, net	(9)	(4)
Net cash provided by operating activities	628	1,886
Cash flows from investing activities:		
Capital expenditures	(537)	(551)
Deferred turnaround and catalyst costs	(103)	(129)
Contingent payments in connection with acquisitions	(25)	(50)
Minor acquisitions and other investing activities, net	(51)	7
Net cash used in investing activities	(716)	(723)
Cash flows from financing activities:		
Long-term note repayments	(374)	(183)
Purchase of common stock for treasury	(518)	(904)
Issuance of common stock in connection with employee benefit plans	7	37
Benefit from tax deduction in excess of recognized stock-based compensation cost	8	63
Common stock dividends	(64)	(73)
Net cash used in financing activities	(941)	(1,060)
Effect of foreign exchange rate changes on cash	(4)	3
Net increase (decrease) in cash and temporary cash investments	(1,033)	106
Cash and temporary cash investments at beginning of period	2,464	1,590
Cash and temporary cash investments at end of period	\$ 1,431	\$ 1,696

See Condensed Notes to Consolidated Financial Statements.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONSOLIDATED STATEMENTS OF COMPREHENSIVE INCOME
(Millions of Dollars)
(Unaudited)

	Three Months Ended March	
	2008	31, 2007
Net income	\$ 261	\$ 1,144
Other comprehensive income (loss):		
Foreign currency translation adjustment	(77)	20
Pension and other postretirement benefits net loss reclassified into income, net of income tax benefit of \$0 and \$1	-	1
Net loss on derivative instruments designated and qualifying as cash flow hedges:		
Net loss arising during the period, net of income tax benefit of \$27 and \$23	(49)	(42)
Net gain reclassified into income, net of income tax expense of \$8 and \$6	(15)	(11)
Net loss on cash flow hedges	(64)	(53)
Other comprehensive loss	(141)	(32)
Comprehensive income	\$ 120	\$ 1,112

See Condensed Notes to Consolidated Financial Statements.

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**VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

1. BASIS OF PRESENTATION, PRINCIPLES OF CONSOLIDATION, AND SIGNIFICANT ACCOUNTING POLICIES

As used in this report, the terms Valero, we, us, or our may refer to Valero Energy Corporation, one or more of its consolidated subsidiaries, or all of them taken as a whole.

These unaudited consolidated financial statements include the accounts of Valero and subsidiaries in which Valero has a controlling interest. Intercompany balances and transactions have been eliminated in consolidation. Investments in significant non-controlled entities are accounted for 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 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 financial statements as of that date. For further information, refer to the consolidated financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2007.

Use of Estimates

The preparation of financial statements in conformity with GAAP requires our management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. On an ongoing basis, management reviews its estimates based on currently available information. Changes in facts and circumstances may result in revised estimates.

Reclassifications

Previously reported amounts have been reclassified to present the operations of the Lima Refinery as discontinued operations as discussed in Note 3.

2. ACCOUNTING PRONOUNCEMENTS

FASB Statement No. 157

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements. Statement No. 157 defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measures, but does not require any new fair value measurements. Statement No. 157 is effective for fiscal years beginning after November 15, 2007. The provisions of Statement No. 157 are to be applied on a prospective basis, with the exception of certain financial instruments for which retrospective application is required. FASB Staff Position No. FAS 157-2 (FSP 157-2), issued in February 2008, delayed the effective date of Statement No. 157 for nonfinancial assets and nonfinancial

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

liabilities, except for items that are recognized or disclosed at fair value in the financial statements on a recurring basis (at least annually), until fiscal years beginning after November 15, 2008. We adopted Statement No. 157 effective January 1, 2008, with the exceptions allowed under FSP 157-2, the adoption of which has not affected our financial position or results of operations but did result in additional required disclosures, which are provided in Note 9. The exceptions apply to the following: nonfinancial assets and nonfinancial liabilities measured at fair value in a business combination; impaired property, plant and equipment; goodwill; and the initial recognition of the fair value of asset retirement obligations and restructuring costs. We do not expect any significant impact to our consolidated financial statements when we implement Statement No. 157 for these assets and liabilities.

FASB Statement No. 159

In February 2007, the FASB issued Statement No. 159, *The Fair Value Option for Financial Assets and Financial Liabilities Including an Amendment of FASB Statement No. 115*. Statement No. 159 permits entities to choose to measure many financial instruments and certain other items at fair value that are not currently required to be measured at fair value. Statement No. 159 is effective for fiscal years beginning after November 15, 2007. We have not elected to apply the provisions of Statement No. 159 to any of our financial instruments as of March 31, 2008; therefore, the adoption of Statement No. 159 effective January 1, 2008 has not affected our financial position or results of operations.

FASB Statement No. 141 (revised 2007)

In December 2007, the FASB issued Statement No. 141 (revised 2007), *Business Combinations* (Statement No. 141R). This statement improves the financial reporting of business combinations and clarifies the accounting for these transactions. The provisions of Statement No. 141R are to be applied prospectively to business combinations with acquisition dates on or after the beginning of an entity's fiscal year that begins on or after December 15, 2008, with early adoption prohibited. Due to its application to future acquisitions, the adoption of Statement No. 141R effective January 1, 2009 will not have any immediate effect on our financial position or results of operations.

FASB Statement No. 160

In December 2007, the FASB issued Statement No. 160, *Noncontrolling Interests in Consolidated Financial Statements* an amendment of ARB No. 51. Statement No. 160 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008. This statement provides guidance for the accounting and reporting of noncontrolling interests, changes in controlling interests, and the deconsolidation of subsidiaries. In addition, Statement No. 160 amends FASB Statement No. 128, *Earnings per Share*, to specify the computation, presentation, and disclosure requirements for earnings per share if an entity has one or more noncontrolling interests. The adoption of Statement No. 160 effective January 1, 2009 is not expected to materially affect our financial position or results of operations.

FASB Statement No. 161

In March 2008, the FASB issued Statement No. 161, *Disclosures about Derivative Instruments and Hedging Activities*. Statement No. 161 establishes, among other things, the disclosure requirements for derivative instruments and for hedging activities. This statement requires qualitative disclosures about objectives and strategies for using derivatives, quantitative disclosures about fair value amounts of and gains and losses on derivative instruments, and disclosures about contingent features related to credit risk in derivative agreements. Statement No. 161 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after November 15, 2008. Since Statement No. 161 only affects disclosure

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

requirements, the adoption of Statement No. 161 will not affect our financial position or results of operations.

3. DISPOSITION OF LIMA REFINERY

Effective July 1, 2007, we sold our refinery in Lima, Ohio to Husky Refining Company, a wholly owned subsidiary of Husky Energy Inc. As a result, the consolidated statement of income for the three months ended March 31, 2007 reflects the operations related to the Lima Refinery in income from discontinued operations, net of income tax expense. Financial information related to the Lima Refinery operations for the three months ended March 31, 2007 were as follows (in millions):

Operating revenues	\$ 943
Income before income tax expense	91

4. INVENTORIES

Inventories consisted of the following (in millions):

	March 31, 2008	December 31, 2007
Refinery feedstocks	\$ 2,359	\$ 1,739
Refined products and blendstocks	2,025	2,188
Convenience store merchandise	83	85
Materials and supplies	176	172
Inventories	\$ 4,643	\$ 4,184

As of March 31, 2008 and December 31, 2007, the replacement cost (market value) of LIFO inventories exceeded their LIFO carrying amounts by approximately \$7.1 billion and \$6.2 billion, respectively.

5. DEBT

On February 1, 2008, we redeemed our 9.50% senior notes for \$367 million, or 104.750% of stated value. These notes had a carrying amount of \$381 million on the date of redemption, resulting in a gain of \$14 million that was included in other income, net in the consolidated statement of income. In addition, in March 2008, we made a scheduled debt repayment of \$7 million related to certain of our other debt.

During the three months ended March 31, 2008, we had no borrowings under our revolving credit facilities or our short-term uncommitted bank credit facilities.

6. STOCKHOLDERS EQUITY**Treasury Stock**

During the three months ended March 31, 2008 and 2007, we purchased 8.8 million and 15.6 million shares of our common stock at a cost of \$518 million and \$904 million, respectively, in connection with the administration of our employee benefit plans and common stock purchase programs authorized by our board of directors. During the three months ended March 31, 2008, we issued 0.6 million shares from

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

treasury at an average cost of \$67.37 per share, and for the three months ended March 31, 2007, we issued 3.8 million shares from treasury at an average cost of \$58.63 per share, for our employee benefit plans.

On February 28, 2008, our board of directors approved a new \$3 billion common stock purchase program. This program is in addition to the remaining amount under the \$6 billion program previously authorized. This new \$3 billion program has no expiration date. As of March 31, 2008, we had made no purchases of our common stock under the new \$3 billion program.

Common Stock Dividends

On May 1, 2008, our board of directors declared a regular quarterly cash dividend of \$0.15 per common share payable on June 18, 2008 to holders of record at the close of business on May 28, 2008.

7. EARNINGS PER COMMON SHARE

Earnings per common share amounts from continuing operations were computed as follows (dollars and shares in millions, except per share amounts):

	Three Months Ended March	
	31,	
	2008	2007
Earnings per common share from continuing operations:		
Income from continuing operations	\$ 261	\$ 1,088
Weighted-average common shares outstanding	532	599
Earnings per common share from continuing operations	\$ 0.49	\$ 1.82
Earnings per common share from continuing operations assuming dilution:		
Income from continuing operations	\$ 261	\$ 1,088
Weighted-average common shares outstanding	532	599
Effect of dilutive securities:		
Stock options	8	15
Performance awards and other benefit plans	1	1
Weighted-average common shares outstanding assuming dilution	541	615
Earnings per common share from continuing operations assuming dilution	\$ 0.48	\$ 1.77

Approximately 2 million outstanding stock options were not included in the computation of dilutive securities for the three months ended March 31, 2008 because the options' exercise prices were greater than the average market price of the common shares during the reporting period, and therefore the effect of including such options would be anti-dilutive.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. STATEMENTS OF CASH FLOWS

In order to determine net cash provided by operating activities, net income is adjusted by, among other things, changes in current assets and current liabilities as follows (in millions):

	Three Months Ended March	
	2008	31, 2007
Decrease (increase) in current assets:		
Restricted cash	\$ (10)	\$ -
Receivables, net	1,663	221
Inventories	(469)	(402)
Income taxes receivable	-	32
Prepaid expenses and other	47	32
Increase (decrease) in current liabilities:		
Accounts payable	(771)	115
Accrued expenses	(82)	(75)
Taxes other than income taxes	(93)	(7)
Income taxes payable	(296)	422
Changes in current assets and current liabilities	\$ (11)	\$ 338

The above changes in current assets and current liabilities differ from changes between amounts reflected in the applicable consolidated balance sheets for the respective periods for the following reasons:

the amounts shown above exclude changes in cash and temporary cash investments, deferred income taxes, and current portion of long-term debt and capital lease obligations, as well as the effect of certain noncash investing and financing activities discussed below;

previously accrued capital expenditures, deferred turnaround and catalyst costs, and contingent earn-out payments are reflected in investing activities in the consolidated statements of cash flows;

changes in assets held for sale and liabilities related to assets held for sale related to the Lima Refinery from December 31, 2006 to March 31, 2007 are reflected in the line item to which the changes relate in the table above; and

certain differences between consolidated balance sheet changes and consolidated statement of cash flow changes reflected above result from translating foreign currency denominated amounts at different exchange rates.

Noncash financing activities for the three months ended March 31, 2008 included the reversal of an accrual of \$158 million at December 31, 2007 for common stock purchases in the open market that were not settled and paid until January 2008. There were no significant noncash investing activities for the three months ended March 31, 2008. Noncash financing activities for the three months ended March 31, 2007 included the accrual of \$137 million of common stock purchases in the open market for which settlement and payment occurred in April 2007. There were no significant noncash investing activities for the three months ended March 31, 2007.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Cash flows related to the discontinued operations of the Lima Refinery have been combined with the cash flows from continuing operations within each category in the consolidated statement of cash flows for the three months ended March 31, 2007. Cash provided by operating activities related to our discontinued operations was \$65 million for the three months ended March 31, 2007. Cash used in investing activities related to the Lima Refinery was \$9 million for the three months ended March 31, 2007.

Cash flows related to interest and income taxes were as follows (in millions):

	Three Months Ended March	
	31,	
	2008	2007
Interest paid (net of amount capitalized)	\$ 16	\$ 13
Income taxes paid (net of tax refunds received)	414	5

9. FAIR VALUE MEASUREMENTS

As discussed in Note 2, we adopted Statement No. 159 effective January 1, 2008, but have not made any fair value elections with respect to any of our eligible assets or liabilities as of March 31, 2008. Also as discussed in Note 2, effective January 1, 2008, we adopted Statement No. 157, which defines fair value, establishes a consistent framework for measuring fair value, establishes a fair value hierarchy (Level 1, Level 2, or Level 3) based on the quality of inputs used to measure fair value, and expands disclosure requirements for fair value measurements.

Pursuant to the provisions of Statement No. 157, fair values determined by Level 1 inputs utilize quoted prices in active markets for identical assets or liabilities. Fair values determined by Level 2 inputs are based on quoted prices for similar assets and liabilities in active markets, and inputs other than quoted prices that are observable for the asset or liability. Level 3 inputs are unobservable inputs for the asset or liability, and include situations where there is little, if any, market activity for the asset or liability. We use appropriate valuation techniques based on the available inputs to measure the fair values of our assets and liabilities. When available, we measure fair value using Level 1 inputs because they generally provide the most reliable evidence of fair value.

The table below presents information (dollars in millions) about our assets and liabilities measured at fair value on a recurring basis and indicates the fair value hierarchy of the inputs utilized by us to determine the fair values as of March 31, 2008. These assets and liabilities have previously been measured at fair value in accordance with existing GAAP, and our accounting for these assets and liabilities was not impacted by our adoption of Statement No. 157 and Statement No. 159. As of March 31, 2008, we did not have any assets or liabilities that had fair values determined by Level 2 or Level 3 inputs.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

	Fair Value Measurements Using			Total as of March 31, 2008
	Quoted Prices in Active Markets (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)	
Assets:				
Commodity derivative contracts	\$ 142	\$ -	\$ -	\$ 142
Nonqualified benefit plans	132	-	-	132
Liabilities:				
Commodity derivative contracts	70	-	-	70
Nonqualified benefit plans	40	-	-	40

10. PRICE RISK MANAGEMENT ACTIVITIES

The net gain (loss) recognized in income representing the amount of hedge ineffectiveness was as follows (in millions):

	Three Months Ended March 31,	
	2008	2007
Fair value hedges	\$ 2	\$ (1)
Cash flow hedges	(10)	1

The above amounts were included in cost of sales in the consolidated statements of income. No component of the derivative instruments gains or losses was excluded from the assessment of hedge effectiveness. No amounts were recognized in income for hedged firm commitments that no longer qualify as fair value hedges.

For cash flow hedges, gains and losses reported in accumulated other comprehensive income in the consolidated balance sheets are reclassified into cost of sales when the forecasted transactions affect income. During the three months ended March 31, 2008, we recognized in accumulated other comprehensive income unrealized after-tax losses of \$49 million on certain cash flow hedges, primarily related to forward sales of distillates and associated forward purchases of crude oil, with \$47 million of cumulative after-tax losses on cash flow hedges remaining in accumulated other comprehensive income as of March 31, 2008. We expect that the deferred losses as of March 31, 2008 will be reclassified into cost of sales over the next nine months as a result of hedged transactions that are forecasted to occur. The amount ultimately realized in income, however, will differ as commodity prices change. For the three months ended March 31, 2008 and 2007, there were no amounts reclassified from accumulated other comprehensive income into income as a result of the discontinuance of cash flow hedge accounting.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. SEGMENT INFORMATION

Segment information for our two reportable segments, refining and retail, was as follows (in millions):

	Refining	Retail	Corporate	Total
Three months ended March 31, 2008:				
Operating revenues from external customers	\$ 25,430	\$ 2,515	\$ -	\$ 27,945
Intersegment revenues	1,900	-	-	1,900
Operating income (loss)	568	50	(146)	472

Three months ended March 31, 2007:

Operating revenues from external customers	\$ 16,849	\$ 1,906	\$ -	\$ 18,755
Intersegment revenues	1,309	-	-	1,309
Operating income (loss)	1,776	53	(156)	1,673

Total assets by reportable segment were as follows (in millions):

	March 31, 2008	December 31, 2007
Refining	\$ 36,516	\$ 37,703
Retail	2,104	2,098
Corporate	2,049	2,921
Total consolidated assets	\$ 40,669	\$ 42,722

The entire balance of goodwill as of March 31, 2008 and December 31, 2007 has been included in the total assets of the refining reportable segment.

12. EMPLOYEE BENEFIT PLANS

The components of net periodic benefit cost related to our defined benefit plans were as follows for the three months ended March 31, 2008 and 2007 (in millions):

	Pension Plans		Other Postretirement Benefit Plans	
	2008	2007	2008	2007
Components of net periodic benefit cost:				
Service cost	\$ 23	\$ 24	\$ 3	\$ 3
Interest cost	19	18	7	7
Expected return on plan assets	(26)	(21)	-	-
Amortization of:				
Prior service cost (credit)	1	1	(2)	(3)
Net loss	-	2	1	2
Net periodic benefit cost	\$ 17	\$ 24	\$ 9	\$ 9

Our anticipated contributions to our qualified pension plans during 2008 have not changed from amounts previously disclosed in our consolidated financial statements for the year ended December 31, 2007.

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**VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

There were no contributions made during the three months ended March 31, 2008 and 2007. In April 2008, we made a \$20 million contribution to our qualified pension plans.

13. COMMITMENTS AND CONTINGENCIES

Accounts Receivable Sales Facility

As of March 31, 2008, we had an accounts receivable sales facility with a group of third-party financial institutions to sell on a revolving basis up to \$1 billion of eligible trade receivables, which matures in August 2008. As of March 31, 2008 and December 31, 2007, the amount of eligible receivables sold to the third-party financial institutions was \$100 million.

Contingent Earn-Out Agreements

In January 2008 and January 2007, we made previously accrued earn-out payments of \$25 million and \$50 million, respectively, related to the acquisition of the St. Charles Refinery. As of March 31, 2008, aggregate earn-out payments related to the St. Charles Refinery totaled \$175 million, which was the aggregate limit under that agreement. As of March 31, 2008, we have no further commitments with respect to contingent earn-out agreements.

Insurance Recoveries

During the first quarter of 2007, our McKee Refinery was shut down due to a fire originating in its propane deasphalting unit, resulting in business interruption losses for which we submitted claims to our insurance carriers under our insurance policies. We have reached a settlement with the insurance carriers on our claims, resulting in pre-tax income of approximately \$100 million in the first quarter of 2008 that was recorded as a reduction to cost of sales.

Tax Matters

We are subject to extensive tax liabilities, including federal, state, and foreign income taxes and transactional taxes such as excise, sales/use, payroll, franchise, withholding, and ad valorem taxes. New tax laws and regulations and changes in existing tax laws and regulations are continuously being enacted or proposed that could result in increased expenditures for tax liabilities in the future. Many of these liabilities are subject to periodic audits by the respective taxing authority. Subsequent changes to our tax liabilities as a result of these audits may subject us to interest and penalties.

Effective January 1, 2007, the Government of Aruba (GOA) enacted a turnover tax on revenues from the sale of goods produced and services rendered in Aruba. The turnover tax, which is 3% for on-island sales and services and 1% on export sales, is being assessed by the GOA on sales by our Aruba Refinery. However, due to a previous tax holiday that was granted to our Aruba Refinery by the GOA through December 31, 2010 as well as other reasons, we believe that exports by our Aruba Refinery should not be subject to this turnover tax. Accordingly, no expense or liability has been recognized in our consolidated financial statements with respect to this turnover tax on exports. We have commenced arbitration proceedings with the Netherlands Arbitration Institute pursuant to which we will seek to enforce our rights under the tax holiday. We have also filed protests of these assessments through proceedings in Aruba. In April 2008, we entered into an escrow agreement with the GOA and Caribbean Mercantile Bank NV (CMB), pursuant to which we agreed to deposit an amount equal to the disputed turnover tax on exports into an escrow account with CMB, pending resolution of the tax protest proceedings in Aruba. Under this escrow agreement, we are required to continue to deposit an amount equal to the disputed tax

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**VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

on a monthly basis until the tax dispute is resolved through the Aruba proceedings. Amounts deposited under this escrow agreement will be reflected as restricted cash in our consolidated balance sheet.

Aruba Refinery Fire

On January 25, 2008, our Aruba Refinery was shut down due to a fire in its vacuum unit. We resumed partial operation of the refinery in mid-February, and we are in the process of completing the repairs and expect to resume full operations in the second quarter of 2008. We do not believe that this incident will have a material adverse effect on our results of operations for 2008.

Litigation

MTBE Litigation

As of May 1, 2008, we were named as a defendant in 83 cases alleging liability related to MTBE contamination in groundwater. The plaintiffs are generally water providers, governmental authorities, and private water companies alleging that refiners and marketers of MTBE and gasoline containing MTBE are liable for manufacturing or distributing a defective product. We have been named in these lawsuits together with many other refining industry companies. We are being sued primarily as a refiner and marketer of MTBE and gasoline containing MTBE. We do not own or operate gasoline station facilities in most of the geographic locations in which damage is alleged to have occurred. The lawsuits generally seek individual, unquantified compensatory and punitive damages, injunctive relief, and attorneys' fees.

We, together with several other refining industry defendants, and the plaintiffs have reached an agreement in principle to settle 59 of the 83 cases, including the *Suffolk County Water Authority* case, which is scheduled for trial in September 2008. Under the proposed settlement, we are assigned a percentage of the aggregate settlement amount, which will require us to make an insignificant cash payment. We will also commit to participate with other defendants in contingent future treatment of water supply wells under certain defined circumstances. We anticipate that a portion of our payment will be funded by third parties. The settlement will not become effective until it is approved by the court, which we expect will occur sometime in the late second quarter or early third quarter of 2008.

Most of the 24 cases that are not subject to the proposed settlement are pending in federal court and are consolidated for pre-trial proceedings in the U.S. District Court for the Southern District of New York (Multi-District Litigation Docket No. 1358, *In re: Methyl-Tertiary Butyl Ether Products Liability Litigation*). A 2007 ruling on jurisdiction from the U.S. Court of Appeals for the Second Circuit has resulted in a remand of two cases to state court (*People of the State of New Hampshire* and *People of the State of California*). Discovery is now open in all cases. We believe that we have strong defenses to all claims and are vigorously defending the remaining cases.

We have recorded a loss contingency liability with respect to our MTBE litigation portfolio in accordance with FASB Statement No. 5, *Accounting for Contingencies*. However, due to the inherent uncertainty of litigation, we believe that it is reasonably possible (as defined in FASB Statement No. 5) that we may suffer a loss with respect to one or more of the lawsuits in excess of the amount accrued. We believe that such an outcome in any one of these lawsuits would not have a material adverse effect on our results of operations or financial position. However, we believe that an adverse result in all or a substantial number of these cases could have a material effect on our results of operations and financial position. An estimate of the possible loss or range of loss from an adverse result in all or substantially all of these cases cannot reasonably be made.

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**VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

Retail Fuel Temperature Litigation

As of May 1, 2008, we were named in 22 consumer class action lawsuits relating to fuel temperature. We have been named in these lawsuits together with several other defendants in the retail petroleum marketing business. The complaints, filed in federal courts in several states, allege that because fuel volume increases with fuel temperature, the defendants have violated state consumer protection laws by failing to adjust the volume of fuel when the fuel temperature exceeded 60 degrees Fahrenheit. The complaints seek to certify classes of retail consumers who purchased fuel in various locations. The complaints seek an order compelling the installation of temperature correction devices as well as associated monetary relief. In June 2007, the federal lawsuits were consolidated into a multi-district litigation case in the U.S. District Court for the District of Kansas (Multi-District Litigation Docket No. 1840, *In re: Motor Fuel Temperature Sales Practices Litigation*). In February 2008, the court denied the defendants' motion to dismiss the complaints. We believe that we have several strong defenses to these lawsuits and intend to contest them. We have not recorded a loss contingency liability with respect to this matter, but due to the inherent uncertainty of litigation, we believe that it is reasonably possible (as defined in FASB Statement No. 5) that we may suffer a loss with respect to one or more of the lawsuits. An estimate of the possible loss or range of loss from an adverse result in all or substantially all of these cases cannot reasonably be made.

Rosolowski

Rosolowski v. Clark Refining & Marketing, Inc., et al., Judicial Circuit Court, Cook County, Illinois (Case No. 95-L-014703). We assumed this class action lawsuit in the Premcor Acquisition. The lawsuit, filed in 1995, relates in part to a release to the atmosphere of spent catalyst containing low levels of metals from the now-closed Blue Island, Illinois refinery in 1994. The case was certified as a class action in 2000 with three classes, two of which received nominal or no damages, and one of which received a sizeable jury verdict. That class consisted of local residents who claimed property damage or loss of use and enjoyment of their property over a period of several years. In November 2005, the jury returned a verdict for the plaintiffs of \$80.1 million in compensatory damages and \$40 million in punitive damages. However, following our motions for new trial and judgment notwithstanding the verdict (citing, among other things, misconduct by plaintiffs' counsel and improper class certification), the trial judge in November 2006 vacated the jury's award and decertified the class. Plaintiffs have appealed the court's decision to vacate the \$120 million judgment and decertify the class. Oral arguments on plaintiffs' appeal were heard before the state appeals court on February 20, 2008. We have recorded a loss contingency liability with respect to this matter in accordance with FASB Statement No. 5. We do not believe that this matter will have a material effect on our financial position or results of operations.

Other Litigation

We are also a party to additional claims and legal proceedings arising in the ordinary course of business. We believe that there is only a remote likelihood that future costs related to known contingent liabilities related to these legal proceedings would have a material adverse impact on our consolidated results of operations or financial position.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

14. CONDENSED CONSOLIDATING FINANCIAL INFORMATION

In conjunction with the acquisition of Premcor Inc. on September 1, 2005, Valero Energy Corporation has fully and unconditionally guaranteed the following debt of The Premcor Refining Group Inc. (PRG), a wholly owned subsidiary of Valero Energy Corporation, that was outstanding as of March 31, 2008:

- 6.75% senior notes due February 2011,
- 6.125% senior notes due May 2011,
- 6.75% senior notes due May 2014, and
- 7.5% senior notes due June 2015.

In addition, PRG has fully and unconditionally guaranteed all of the outstanding debt issued by Valero Energy Corporation.

The following condensed consolidating financial information is provided for Valero and PRG as an alternative to providing separate financial statements for PRG. The accounts for all companies reflected herein are presented using the equity method of accounting for investments in subsidiaries.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
Condensed Consolidating Balance Sheet as of March 31, 2008
(unaudited, in millions)

	Valero Energy Corporation	PRG	Other Non- Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Current assets:					
Cash and temporary cash investments	\$ 794	\$ -	\$ 637	\$ -	\$ 1,431
Restricted cash	23	2	16	-	41
Receivables, net	-	106	5,903	-	6,009
Inventories	-	466	4,177	-	4,643
Deferred income taxes	-	-	271	-	271
Prepaid expenses and other	-	7	112	-	119
Total current assets	817	581	11,116	-	12,514
Property, plant and equipment, at cost	-	6,816	19,473	-	26,289
Accumulated depreciation	-	(477)	(3,828)	-	(4,305)
Property, plant and equipment, net	-	6,339	15,645	-	21,984
Intangible assets, net	-	1	274	-	275
Goodwill	-	1,816	2,244	-	4,060
Investment in Valero Energy affiliates	7,136	1,222	(48)	(8,310)	-
Long-term notes receivable from affiliates	16,414	-	-	(16,414)	-
Deferred income tax receivable	475	-	-	(475)	-
Deferred charges and other assets, net	389	153	1,294	-	1,836
Total assets	\$ 25,231	\$ 10,112	\$ 30,525	\$ (25,199)	\$ 40,669
LIABILITIES AND STOCKHOLDERS EQUITY					
Current liabilities:					
Current portion of long-term debt and capital lease obligations	\$ -	\$ -	\$ 3	\$ -	\$ 3
Accounts payable	97	380	8,158	-	8,635
Accrued expenses	162	45	283	-	490
Taxes other than income taxes	-	13	521	-	534
Income taxes payable	117	84	1	-	202
Deferred income taxes	293	-	-	-	293
Total current liabilities	669	522	8,966	-	10,157

Long-term debt and capital lease obligations, less current portion	5,530	902	39	-	6,471
Long-term notes payable to affiliates	-	7,000	9,414	(16,414)	-
Deferred income taxes	-	1,547	2,936	(475)	4,008
Other long-term liabilities	800	189	812	-	1,801
Stockholders' equity:					
Common stock	6	-	2	(2)	6
Additional paid-in capital	7,258	75	2,471	(2,546)	7,258
Treasury stock	(6,574)	-	-	-	(6,574)
Retained earnings	17,110	(121)	5,936	(5,815)	17,110
Accumulated other comprehensive income (loss)	432	(2)	(51)	53	432
Total stockholders' equity	18,232	(48)	8,358	(8,310)	18,232
Total liabilities and stockholders' equity	\$ 25,231	\$ 10,112	\$ 30,525	\$ (25,199)	\$ 40,669

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
Condensed Consolidating Balance Sheet as of December 31, 2007
(in millions)

	Valero Energy Corporation	PRG	Other Non- Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Current assets:					
Cash and temporary cash investments	\$ 1,414	\$ -	\$ 1,050	\$ -	\$ 2,464
Restricted cash	23	2	6	-	31
Receivables, net	1	119	7,571	-	7,691
Inventories	-	569	3,615	-	4,184
Deferred income taxes	-	-	247	-	247
Prepaid expenses and other	-	11	164	-	175
Total current assets	1,438	701	12,653	-	14,792
Property, plant and equipment, at cost					
	-	6,681	19,106	-	25,787
Accumulated depreciation	-	(420)	(3,658)	-	(4,078)
Property, plant and equipment, net	-	6,261	15,448	-	21,709
Intangible assets, net					
Goodwill	-	2	288	-	290
Investment in Valero Energy affiliates	-	1,816	2,245	-	4,061
Long-term notes receivable from affiliates	7,080	1,183	73	(8,336)	-
Deferred charges and other assets, net	17,321	-	-	(17,321)	-
	386	165	1,319	-	1,870
Total assets	\$ 26,225	\$ 10,128	\$ 32,026	\$ (25,657)	\$ 42,722
LIABILITIES AND STOCKHOLDERS EQUITY					
Current liabilities:					
Current portion of long-term debt and capital lease obligations	\$ 7	\$ 382	\$ 3	\$ -	\$ 392
Accounts payable	234	302	9,060	-	9,596
Accrued expenses	79	55	368	-	502

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Taxes other than income taxes	-	25	607	-	632
Income taxes payable	227	115	157	-	499
Deferred income taxes	21	272	-	-	293
Total current liabilities	568	1,151	10,195	-	11,914
Long-term debt and capital lease obligations, less current portion	5,527	903	40	-	6,470
Long-term notes payable to affiliates	-	7,763	9,558	(17,321)	-
Deferred income taxes	852	57	3,112	-	4,021
Other long-term liabilities	771	181	858	-	1,810
Stockholders' equity:					
Common stock	6	-	2	(2)	6
Additional paid-in capital	7,111	75	2,486	(2,561)	7,111
Treasury stock	(6,097)	-	-	-	(6,097)
Retained earnings	16,914	-	5,764	(5,764)	16,914
Accumulated other comprehensive income (loss)	573	(2)	11	(9)	573
Total stockholders' equity	18,507	73	8,263	(8,336)	18,507
Total liabilities and stockholders' equity	\$ 26,225	\$ 10,128	\$ 32,026	\$ (25,657)	\$ 42,722

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
Condensed Consolidating Statement of Income for the Three Months Ended March 31, 2008
(unaudited, in millions)

	Valero Energy Corporation	PRG	Other Non- Guarantor Subsidiaries	Eliminations	Consolidated
Operating revenues	\$ -	\$ 7,674	\$ 27,605	\$ (7,334)	\$ 27,945
Costs and expenses:					
Cost of sales	-	7,419	25,584	(7,334)	25,669
Refining operating expenses					