

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.

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

|  | <b>March 31,<br/>2008<br/>(Unaudited)</b> | <b>December<br/>31,<br/>2007</b> |
|--|---|----------------------------------|
| <b>ASSETS</b>  |   |                                  |
| 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                        |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                         |   |                                  |
| 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           |
| <br>Total stockholders' equity   | <br>18,232    | <br>18,507    |
| <br>Total liabilities and stockholders' equity   | <br>\$ 40,669 | <br>\$ 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)

|  | <b>Three Months Ended March</b> |             |
|--|---------------------------------|-------------|
|  | <b>31,</b>                      |             |
|  | <b>2008</b>                     | <b>2007</b> |
| 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)

|   | <b>Three Months Ended March</b> |                     |
|---|---------------------------------|---------------------|
|   | <b>2008</b>                     | <b>31,<br/>2007</b> |
| <b>Cash flows from operating activities:</b>                                      |                                 |                     |
| 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               |
| <b>Cash flows from investing activities:</b>                                      |                                 |                     |
| 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)               |
| <b>Cash flows from financing activities:</b>                                      |                                 |                     |
| 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                   |
| <b>Net increase (decrease) in cash and temporary cash investments</b>             | <b>(1,033)</b>                  | <b>106</b>          |
| <b>Cash and temporary cash investments at beginning of period</b>                 | <b>2,464</b>                    | <b>1,590</b>        |
| <b>Cash and temporary cash investments at end of period</b>                       | <b>\$ 1,431</b>                 | <b>\$ 1,696</b>     |

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)

|   | <b>Three Months Ended March</b> |                     |
|---|---------------------------------|---------------------|
|   | <b>2008</b>                     | <b>31,<br/>2007</b> |
| 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):

|                                  | <b>March 31,<br/>2008</b> | <b>December<br/>31,<br/>2007</b> |
|----------------------------------|---------------------------|----------------------------------|
| 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):

|   | <b>Three Months Ended March</b> |             |
|---|---------------------------------|-------------|
|   | <b>31,</b>                      |             |
|   | <b>2008</b>                     | <b>2007</b> |
| 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):

|   | <b>Three Months Ended March</b> |                     |
|---|---------------------------------|---------------------|
|   | <b>2008</b>                     | <b>31,<br/>2007</b> |
| 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                 |
| <br>  |                                 |                     |
| 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):

|   | <b>Three Months Ended March</b> |             |
|---|---------------------------------|-------------|
|   | <b>31,</b>                      |             |
|   | <b>2008</b>                     | <b>2007</b> |
| 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<br>March 31,<br>2008 |
|--------------------------------|---|---|--|----------------------------------|
|                                | Quoted<br>Prices<br>in Active<br>Markets<br><br>(Level 1) | Significant<br>Other<br>Observable<br>Inputs<br><br>(Level 2) | Significant<br>Unobservable<br>Inputs<br><br>(Level 3) |                                  |
| <b>Assets:</b>                 |   |   |  |                                  |
| Commodity derivative contracts | \$ 142  | \$ -  | \$ -   | \$ 142                           |
| Nonqualified benefit plans     | 132   | -   | -  | 132                              |
| <b>Liabilities:</b>            |   |   |  |                                  |
| 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<br>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):

|  | <b>Refining</b> | <b>Retail</b> | <b>Corporate</b> | <b>Total</b> |
|--|-----------------|---------------|------------------|--------------|
| <b>Three months ended March 31, 2008:</b>  |                 |               |                  |              |
| 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):

|                           | <b>March 31,<br/>2008</b> | <b>December<br/>31,<br/>2007</b> |
|---------------------------|---------------------------|----------------------------------|
| 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):

|  | <b>Pension Plans</b> |             | <b>Other<br/>Postretirement<br/>Benefit Plans</b> |             |
|--|----------------------|-------------|---|-------------|
|  | <b>2008</b>          | <b>2007</b> | <b>2008</b>                                       | <b>2007</b> |
| 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)**

|   | <b>Valero<br/>Energy<br/>Corporation</b> | <b>PRG</b>       | <b>Other<br/>Non-<br/>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|--|------------------|--|---------------------|---------------------|
| <b>ASSETS</b>   |  |                  |  |                     |                     |
| 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                 |
| <b>Total current assets</b>                                     | <b>817</b>                               | <b>581</b>       | <b>11,116</b>  | <b>-</b>            | <b>12,514</b>       |
|   |  |                  |  |                     |                     |
| Property, plant and equipment, at cost                          | -  | 6,816            | 19,473   | -                   | 26,289              |
| Accumulated depreciation  | -  | (477)            | (3,828)  | -                   | (4,305)             |
| <b>Property, plant and equipment, net</b>                       | <b>-</b>                                 | <b>6,339</b>     | <b>15,645</b>  | <b>-</b>            | <b>21,984</b>       |
|   |  |                  |  |                     |                     |
| 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               |
| <b>Total assets</b>   | <b>\$ 25,231</b>                         | <b>\$ 10,112</b> | <b>\$ 30,525</b>                                     | <b>\$ (25,199)</b>  | <b>\$ 40,669</b>    |
|   |  |                  |  |                     |                     |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                      |  |                  |  |                     |                     |
| 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                 |
| <b>Total current liabilities</b>                                | <b>669</b>                               | <b>522</b>       | <b>8,966</b>   | <b>-</b>            | <b>10,157</b>       |

|  |           |           |           |             |           |
|--|-----------|-----------|-----------|-------------|-----------|
| 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)

|   | <b>Valero<br/>Energy<br/>Corporation</b> | <b>PRG</b>       | <b>Other<br/>Non-<br/>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|--|------------------|--|---------------------|---------------------|
| <b>ASSETS</b>   |  |                  |  |                     |                     |
| 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                 |
| <b>Total current assets</b>                                     | <b>1,438</b>                             | <b>701</b>       | <b>12,653</b>  | <b>-</b>            | <b>14,792</b>       |
| Property, plant and equipment, at cost                          |  |                  |  |                     |                     |
|   | -  | 6,681            | 19,106   | -                   | 25,787              |
| Accumulated depreciation  | -  | (420)            | (3,658)  | -                   | (4,078)             |
| <b>Property, plant and equipment, net</b>                       | <b>-</b>                                 | <b>6,261</b>     | <b>15,448</b>  | <b>-</b>            | <b>21,709</b>       |
| Intangible assets, net  |  |                  |  |                     |                     |
| Goodwill  | -  | 2                | 288  | -                   | 290                 |
| Investment in Valero Energy affiliates                          | 7,080                                    | 1,816            | 2,245  | -                   | 4,061               |
| Long-term notes receivable from affiliates                      | -  | -                | 73   | (8,336)             | -                   |
| Deferred charges and other assets, net                          | 17,321                                   | -                | -  | (17,321)            | -                   |
|   | 386                                      | 165              | 1,319  | -                   | 1,870               |
| <b>Total assets</b>   | <b>\$ 26,225</b>                         | <b>\$ 10,128</b> | <b>\$ 32,026</b>                                     | <b>\$ (25,657)</b>  | <b>\$ 42,722</b>    |
| <b>LIABILITIES AND STOCKHOLDERS EQUITY</b>                      |  |                  |  |                     |                     |
| 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)**

|   | <b>Valero<br/>Energy<br/>Corporation</b> | <b>PRG</b> | <b>Other<br/>Non-<br/>Guarantor<br/>Subsidiaries</b> | <b>Eliminations</b> | <b>Consolidated</b> |
|---|--|------------|--|---------------------|---------------------|
| 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                       | -  | 234        | 880  | -                   | 1,114               |
| Retail selling expenses                           | -  | -          | 188  | -                   | 188                 |
| General and administrative expenses               | (1)                                      | 13         | 123  | -                   | 135                 |
| Depreciation and amortization expense             | -  | 78         | 289  | -                   | 367                 |
| Total costs and expenses                          | (1)                                      | 7,744      | 27,064   | (7,334)             | 27,473              |
| Operating income (loss)                           | 1  | (70)       | 541  | -                   | 472                 |
| Equity in earnings of subsidiaries                | 136                                      | 39         | (121)  | (54)                | -                   |
| Other income (expense), net                       | 292                                      | (8)        | 192  | (456)               | 20                  |
| Interest and debt expense:                        |  |            |  |                     |                     |
| Incurred  | (137)                                    | (148)      | (287)  | 456                 | (116)               |
| Capitalized                                       | -  | 4          | 15   | -                   | 19                  |
| Income (loss) before income tax expense (benefit) | 292                                      | (183)      | 340  | (54)                | 395                 |
| Income tax expense (benefit) (1)                  | 31                                       | (62)       | 165  | -                   | 134                 |
| Net income (loss)                                 | \$ 261                                   | \$ (121)   | \$ 175   | \$ (54)             | \$ 261              |

(1) The income tax expense (benefit) reflected in each column does not include any tax effect of the equity in earnings of subsidiaries.

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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, 2007**  
**(unaudited, in millions)**

|   | Valero<br>Energy<br>Corporation | PRG      | Other<br>Non-<br>Guarantor<br>Subsidiaries | Eliminations | Consolidated |
|---|---------------------------------|----------|--|--------------|--------------|
| Operating revenues  | \$ -                            | \$ 4,872 | \$ 16,330                                  | \$ (2,447)   | \$ 18,755    |
| Costs and expenses:   |                                 |          |  |              |              |
| Cost of sales   | -                               | 4,281    | 13,676                                     | (2,447)      | 15,510       |
| Refining operating expenses   | -                               | 199      | 735  | -            | 934          |
| Retail selling expenses   | -                               | -        | 171  | -            | 171          |
| General and administrative expenses                                   | -                               | 3        | 142  | -            | 145          |
| Depreciation and amortization expense                                 | -                               | 73       | 249  | -            | 322          |
| Total costs and expenses  | -                               | 4,556    | 14,973                                     | (2,447)      | 17,082       |
| Operating income  | -                               | 316      | 1,357                                      | -            | 1,673        |
| Equity in earnings of subsidiaries                                    | 927                             | 66       | 163  | (1,156)      | -            |
| Other income (expense), net   | 357                             | (32)     | 189  | (509)        | 5            |
| Interest and debt expense:  |                                 |          |  |              |              |
| Incurred  | (94)                            | (162)    | (342)                                      | 509          | (89)         |
| Capitalized   | -                               | 1        | 30   | -            | 31           |
| Income from continuing operations before income tax expense           | 1,190                           | 189      | 1,397                                      | (1,156)      | 1,620        |
| Income tax expense (1)  | 46                              | 90       | 396  | -            | 532          |
| Income from continuing operations                                     | 1,144                           | 99       | 1,001                                      | (1,156)      | 1,088        |
| Income (loss) from discontinued operations, net of income tax expense | -                               | 64       | (8)  | -            | 56           |
| Net income  | \$ 1,144                        | \$ 163   | \$ 993                                     | \$ (1,156)   | \$ 1,144     |

(1)

The income tax expense reflected in each column does not include any tax effect of the equity in earnings of subsidiaries.

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

|  | <b>Valero<br/>Energy<br/>Corporation</b> | <b>PRG</b> | <b>Other<br/>Non-<br/>Guarantor<br/>Subsidiaries</b> | <b>Elimination</b> | <b>Consolidated</b> |
|--|--|------------|--|--------------------|---------------------|
| Net cash provided by operating activities  | \$ 124                                   | \$ 32      | \$ 472   | \$ -               | \$ 628              |
| Cash flows from investing activities:  |  |            |  |                    |                     |
| Capital expenditures   | -  | (106)      | (431)  | -                  | (537)               |
| Deferred turnaround and catalyst costs   | -  | (10)       | (93)   | -                  | (103)               |
| Contingent payments in connection with acquisitions                              | -  | -          | (25)   | -                  | (25)                |
| Net intercompany loans   | (171)                                    | -          | -  | 171                | -                   |
| Minor acquisitions and other investing activities, net                           | -  | -          | (51)   | -                  | (51)                |
| Net cash used in investing activities  | (171)                                    | (116)      | (600)  | 171                | (716)               |
| Cash flows from financing activities:  |  |            |  |                    |                     |
| Long-term note repayments  | (6)                                      | (368)      | -  | -                  | (374)               |
| Purchase of common stock for treasury  | (518)                                    | -          | -  | -                  | (518)               |
| Issuance of common stock in connection with employee benefit plans               | 7  | -          | -  | -                  | 7                   |
| Benefit from tax deduction in excess of recognized stock-based compensation cost | 8  | -          | -  | -                  | 8                   |
| Common stock dividends   | (64)                                     | -          | -  | -                  | (64)                |
| Net intercompany borrowings (repayments)   | -  | 452        | (281)  | (171)              | -                   |
| Net cash provided by (used in) financing activities                              | (573)                                    | 84         | (281)  | (171)              | (941)               |
| Effect of foreign exchange rate changes on cash                                  | -  | -          | (4)  | -                  | (4)                 |
| Net increase (decrease) in cash and temporary cash investments                   | (620)                                    | -          | (413)  | -                  | (1,033)             |
| Cash and temporary cash investments at beginning of period                       | 1,414                                    | -          | 1,050  | -                  | 2,464               |
| Cash and temporary cash investments at end of period                             | \$ 794                                   | \$ -       | \$ 637   | \$ -               | \$ 1,431            |



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**VALERO ENERGY CORPORATION AND SUBSIDIARIES**  
**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**Condensed Consolidating Statement of Cash Flows for the Three Months Ended March 31, 2007**  
**(unaudited, in millions)**

|  | <b>Valero<br/>Energy<br/>Corporation</b> | <b>PRG</b> | <b>Other<br/>Non-<br/>Guarantor<br/>Subsidiaries</b> | <b>Elimination</b> | <b>Consolidated</b> |
|--|--|------------|--|--------------------|---------------------|
| Net cash provided by operating activities  | \$ 725                                   | \$ 209     | \$ 952   | \$ -               | \$ 1,886            |
| Cash flows from investing activities:  |  |            |  |                    |                     |
| Capital expenditures   | -  | (122)      | (429)  | -                  | (551)               |
| Deferred turnaround and catalyst costs   | -  | (14)       | (115)  | -                  | (129)               |
| Contingent payments in connection with acquisitions                              | -  | -          | (50)   | -                  | (50)                |
| Investments in subsidiaries  | (73)                                     | -          | -  | 73                 | -                   |
| Return of investment   | 358                                      | -          | 3  | (361)              | -                   |
| Net intercompany loans   | (133)                                    | -          | -  | 133                | -                   |
| Other investing activities, net  | -  | 7          | -  | -                  | 7                   |
| Net cash provided by (used in) investing activities                              | 152                                      | (129)      | (591)  | (155)              | (723)               |
| Cash flows from financing activities:  |  |            |  |                    |                     |
| Long-term note repayments  | -  | (183)      | -  | -                  | (183)               |
| Purchase of common stock for treasury  | (904)                                    | -          | -  | -                  | (904)               |
| Issuance of common stock in connection with employee benefit plans               | 37                                       | -          | -  | -                  | 37                  |
| Benefit from tax deduction in excess of recognized stock-based compensation cost | 63                                       | -          | -  | -                  | 63                  |
| Common stock dividends   | (73)                                     | -          | -  | -                  | (73)                |
| Dividends to parent  | -  | (3)        | (358)  | 361                | -                   |
| Capital contributions from parent  | -  | -          | 73   | (73)               | -                   |
| Net intercompany borrowings (repayments)   | -  | 106        | 27   | (133)              | -                   |
| Net cash used in financing activities  | (877)                                    | (80)       | (258)  | 155                | (1,060)             |
| Effect of foreign exchange rate changes on cash                                  | -  | -          | 3  | -                  | 3                   |
| Net increase in cash and temporary cash investments                              | -  | -          | 106  | -                  | 106                 |
| Cash and temporary cash investments at beginning of period                       | 712                                      | -          | 878  | -                  | 1,590               |
| Cash and temporary cash investments at end of period                             | \$ 712                                   | \$ -       | \$ 984   | \$ -               | \$ 1,696            |



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

**15. SUBSEQUENT EVENT**

On May 8, 2008, we entered into an agreement to sell our refinery in Krotz Springs, Louisiana to Alon USA Energy Inc. The sales price is \$333 million, plus an amount equal to net working capital at the refinery as of the closing date of the sale, which is expected to occur early in the third quarter of 2008. The sales agreement also includes an earn-out provision under which we will receive additional proceeds if certain average refining margins during the next three years exceed specified levels. Net proceeds from the sale exceed the carrying amount of the net assets being sold. The sale is subject to the receipt of required regulatory approvals.

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

***FORWARD-LOOKING STATEMENTS***

This Form 10-Q, including without limitation our discussion below under the heading *Results of Operations Outlook*, includes forward-looking statements within the meaning of Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934. You can identify our forward-looking statements by the words anticipate, believe, expect, plan, intend, estimate, project, projection, predict, budget, forecast, could, should, may, and similar expressions.

These forward-looking statements include, among other things, statements regarding:

- future refining margins, including gasoline and distillate margins;
- future retail margins, including gasoline, diesel, home heating oil, and convenience store merchandise margins;
- expectations regarding feedstock costs, including crude oil differentials, and operating expenses;
- anticipated levels of crude oil and refined product inventories;
- our anticipated level of capital investments, including deferred refinery turnaround and catalyst costs and capital expenditures for environmental and other purposes, and the effect of those capital investments on our results of operations;
- anticipated trends in the supply of and demand for crude oil and other feedstocks and refined products in the United States, Canada, and elsewhere;
- expectations regarding environmental, tax, and other regulatory initiatives; and
- the effect of general economic and other conditions on refining and retail industry fundamentals.

We based our forward-looking statements on our current expectations, estimates, and projections about ourselves and our industry. We caution that these statements are not guarantees of future performance and involve risks, uncertainties, and assumptions that we cannot predict. In addition, we based many of these forward-looking statements on assumptions about future events that may prove to be inaccurate. Accordingly, our actual results may differ materially from the future performance that we have expressed or forecast in the forward-looking statements. Differences between actual results and any future performance suggested in these forward-looking statements could result from a variety of factors, including the following:

- acts of terrorism aimed at either our facilities or other facilities that could impair our ability to produce or transport refined products or receive feedstocks;
- political and economic conditions in nations that consume refined products, including the United States, and in crude oil producing regions, including the Middle East and South America;
- the domestic and foreign supplies of refined products such as gasoline, diesel fuel, jet fuel, home heating oil, and petrochemicals;
- the domestic and foreign supplies of crude oil and other feedstocks;
- the ability of the members of the Organization of Petroleum Exporting Countries (OPEC) to agree on and to maintain crude oil price and production controls;
- the level of consumer demand, including seasonal fluctuations;
- refinery overcapacity or undercapacity;
- the actions taken by competitors, including both pricing and the expansion and retirement of refining capacity in response to market conditions;
- environmental, tax, and other regulations at the municipal, state, and federal levels and in foreign countries;

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the level of foreign imports of refined products;  
accidents or other unscheduled shutdowns affecting our refineries, machinery, pipelines, or equipment, or those of our suppliers or customers;  
changes in the cost or availability of transportation for feedstocks and refined products;  
the price, availability, and acceptance of alternative fuels and alternative-fuel vehicles;  
delay of, cancellation of, or failure to implement planned capital projects and realize the various assumptions and benefits projected for such projects or cost overruns in constructing such planned capital projects;  
earthquakes, hurricanes, tornadoes, and irregular weather, which can unforeseeably affect the price or availability of natural gas, crude oil and other feedstocks, and refined products;  
rulings, judgments, or settlements in litigation or other legal or regulatory matters, including unexpected environmental remediation costs, in excess of any reserves or insurance coverage;  
legislative or regulatory action, including the introduction or enactment of federal, state, municipal, or foreign legislation or rulemakings, which may adversely affect our business or operations;  
changes in the credit ratings assigned to our debt securities and trade credit;  
changes in currency exchange rates, including the value of the Canadian dollar relative to the U.S. dollar; and overall economic conditions.

Any one of these factors, or a combination of these factors, could materially affect our future results of operations and whether any forward-looking statements ultimately prove to be accurate. Our forward-looking statements are not guarantees of future performance, and actual results and future performance may differ materially from those suggested in any forward-looking statements. We do not intend to update these statements unless we are required by the securities laws to do so.

All subsequent written and oral forward-looking statements attributable to us or persons acting on our behalf are expressly qualified in their entirety by the foregoing. We undertake no obligation to publicly release the results of any revisions to any such forward-looking statements that may be made to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events.

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***OVERVIEW***

In this overview, we describe some of the primary factors that we believe affected our operations in the first quarter of 2008. Our profitability is substantially determined by the spread between the price of refined products and the price of crude oil, referred to as the refined product margin. The weakening of industry fundamentals for refined products that we experienced in the fourth quarter of 2007 continued during the first quarter of 2008. Gasoline margins declined in the first quarter of 2008 compared to the prior year first quarter. The decline was primarily due to increasing costs of crude oil and other feedstocks combined with a decrease in gasoline demand. The increasing costs of crude oil and other feedstocks also negatively affected margins on certain secondary products during the first quarter of 2008, such as asphalt, fuel oils, petroleum coke, and petrochemical feedstocks. However, diesel margins in the first quarter of 2008 were favorable compared to the first quarter of 2007 primarily due to tight supplies combined with continued strong global demand.

Because approximately 60% of our total crude oil throughput represents sour crude oil and acidic sweet crude oil feedstocks that are purchased at prices less than sweet crude oil, our profitability is also significantly affected by the spread between sweet crude oil and sour crude oil prices, referred to as the sour crude oil differential. First quarter 2008 sour crude oil differentials remained wide and improved compared to the 2007 first quarter differentials.

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 reported income from continuing operations of \$261 million, or \$0.48 per share, for the first quarter of 2008, compared to \$1.1 billion, or \$1.77 per share, for the first quarter of 2007. The first quarter 2008 results included approximately \$100 million of pre-tax income, or \$0.12 per share, resulting from a settlement of our business interruption claims related to the fire at our McKee Refinery in the first quarter of 2007. During the first quarter of 2008, we purchased \$518 million of our common stock under our board-authorized programs and repaid \$367 million of callable debt that was due in 2013.

**Table of Contents****RESULTS OF OPERATIONS****First Quarter 2008 Compared to First Quarter 2007****Financial Highlights***(millions of dollars, except per share amounts)*

|  | <b>Three Months Ended March 31,</b> |                 |               |
|--|-------------------------------------|-----------------|---------------|
|  | <b>2008</b>                         | <b>2007 (a)</b> | <b>Change</b> |
| Operating revenues   | \$ 27,945                           | \$ 18,755       | \$ 9,190      |
| Costs and expenses:  |                                     |                 |               |
| Cost of sales  | 25,669                              | 15,510          | 10,159        |
| Refining operating expenses                                    | 1,114                               | 934             | 180           |
| Retail selling expenses  | 188                                 | 171             | 17            |
| General and administrative expenses                            | 135                                 | 145             | (10)          |
| Depreciation and amortization expense:                         |                                     |                 |               |
| Refining   | 331                                 | 293             | 38            |
| Retail   | 25                                  | 18              | 7             |
| Corporate  | 11                                  | 11              | -             |
| Total costs and expenses                                       | 27,473                              | 17,082          | 10,391        |
| Operating income   | 472                                 | 1,673           | (1,201)       |
| Other income, net  | 20                                  | 5               | 15            |
| Interest and debt expense:                                     |                                     |                 |               |
| Incurred   | (116)                               | (89)            | (27)          |
| Capitalized  | 19                                  | 31              | (12)          |
| Income from continuing operations before income tax expense    | 395                                 | 1,620           | (1,225)       |
| Income tax expense   | 134                                 | 532             | (398)         |
| Income from continuing operations                              | 261                                 | 1,088           | (827)         |
| Income from discontinued operations, net of income tax expense | -                                   | 56              | (56)          |
| Net income   | \$ 261                              | \$ 1,144        | \$ (883)      |
| Earnings per common share assuming dilution:                   |                                     |                 |               |
| Continuing operations  | \$ 0.48                             | \$ 1.77         | \$ (1.29)     |
| Discontinued operations  | -                                   | 0.09            | (0.09)        |
| Total  | \$ 0.48                             | \$ 1.86         | \$ (1.38)     |

See the footnote references on page 32.



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**Operating Highlights**  
*(millions of dollars, except per barrel and per gallon amounts)*

|  | <b>Three Months Ended March 31,</b> |             |               |
|--|-------------------------------------|-------------|---------------|
|  | <b>2008</b>                         | <b>2007</b> | <b>Change</b> |
| <b>Refining (a):</b>                           |                                     |             |               |
| Operating income                               | \$ 568                              | \$ 1,776    | \$ (1,208)    |
| Throughput margin per barrel (b)               | \$ 8.48                             | \$ 12.15    | \$ (3.67)     |
| Operating costs per barrel:                    |                                     |             |               |
| Refining operating expenses                    | \$ 4.69                             | \$ 3.78     | \$ 0.91       |
| Depreciation and amortization                  | 1.40                                | 1.18        | 0.22          |
| Total operating costs per barrel               | \$ 6.09                             | \$ 4.96     | \$ 1.13       |
| <br>   |                                     |             |               |
| Throughput volumes (thousand barrels per day): |                                     |             |               |
| Feedstocks:                                    |                                     |             |               |
| Heavy sour crude                               | 582                                 | 690         | (108)         |
| Medium/light sour crude                        | 656                                 | 615         | 41            |
| Acidic sweet crude                             | 73                                  | 84          | (11)          |
| Sweet crude                                    | 629                                 | 705         | (76)          |
| Residuals                                      | 192                                 | 245         | (53)          |
| Other feedstocks                               | 159                                 | 152         | 7             |
| Total feedstocks                               | 2,291                               | 2,491       | (200)         |
| Blendstocks and other                          | 318                                 | 256         | 62            |
| Total throughput volumes                       | 2,609                               | 2,747       | (138)         |
| <br>   |                                     |             |               |
| Yields (thousand barrels per day):             |                                     |             |               |
| Gasolines and blendstocks                      | 1,224                               | 1,249       | (25)          |
| Distillates                                    | 872                                 | 911         | (39)          |
| Petrochemicals                                 | 77                                  | 82          | (5)           |
| Other products (c)                             | 438                                 | 509         | (71)          |
| Total yields                                   | 2,611                               | 2,751       | (140)         |
| <br>   |                                     |             |               |
| <b>Retail U.S.:</b>                            |                                     |             |               |
| Operating income                               | \$ 14                               | \$ 24       | \$ (10)       |
| Company-operated fuel sites (average)          | 950                                 | 963         | (13)          |
| Fuel volumes (gallons per day per site)        | 4,942                               | 4,982       | (40)          |
| Fuel margin per gallon                         | \$ 0.112                            | \$ 0.123    | \$ (0.011)    |
| Merchandise sales                              | \$ 245                              | \$ 233      | \$ 12         |
| Merchandise margin (percentage of sales)       | 30.5%                               | 30.0%       | 0.5%          |
| Margin on miscellaneous sales                  | \$ 28                               | \$ 25       | \$ 3          |
| Retail selling expenses                        | \$ 120                              | \$ 113      | \$ 7          |
| Depreciation and amortization expense          | \$ 17                               | \$ 11       | \$ 6          |

**Retail Canada:**

|  |          |          |          |
|--|----------|----------|----------|
| Operating income                         | \$ 36    | \$ 29    | \$ 7     |
| Fuel volumes (thousand gallons per day)  | 3,278    | 3,370    | (92)     |
| Fuel margin per gallon                   | \$ 0.301 | \$ 0.245 | \$ 0.056 |
| Merchandise sales                        | \$ 46    | \$ 37    | \$ 9     |
| Merchandise margin (percentage of sales) | 28.3%    | 29.4%    | (1.1)%   |
| Margin on miscellaneous sales            | \$ 9     | \$ 9     | \$ -     |
| Retail selling expenses                  | \$ 68    | \$ 58    | \$ 10    |
| Depreciation and amortization expense    | \$ 8     | \$ 7     | \$ 1     |

See the footnote references on page 32.

**Table of Contents****Refining Operating Highlights by Region (d)**  
*(millions of dollars, except per barrel amounts)*

|   | <b>Three Months Ended March 31,</b> |             |               |
|---|-------------------------------------|-------------|---------------|
|   | <b>2008</b>                         | <b>2007</b> | <b>Change</b> |
| <b>Gulf Coast:</b>                            |                                     |             |               |
| Operating income                              | \$ 437                              | \$ 1,083    | \$ (646)      |
| Throughput volumes (thousand barrels per day) | 1,380                               | 1,525       | (145)         |
| Throughput margin per barrel (b)              | \$ 9.51                             | \$ 12.35    | \$ (2.84)     |
| Operating costs per barrel:                   |                                     |             |               |
| Refining operating expenses                   | \$ 4.72                             | \$ 3.45     | \$ 1.27       |
| Depreciation and amortization                 | 1.31                                | 1.01        | 0.30          |
| Total operating costs per barrel              | \$ 6.03                             | \$ 4.46     | \$ 1.57       |
| <b>Mid-Continent (a):</b>                     |                                     |             |               |
| Operating income                              | \$ 115                              | \$ 91       | \$ 24         |
| Throughput volumes (thousand barrels per day) | 412                                 | 353         | 59            |
| Throughput margin per barrel (b)              | \$ 8.74                             | \$ 9.31     | \$ (0.57)     |
| Operating costs per barrel:                   |                                     |             |               |
| Refining operating expenses                   | \$ 4.34                             | \$ 4.73     | \$ (0.39)     |
| Depreciation and amortization                 | 1.33                                | 1.68        | (0.35)        |
| Total operating costs per barrel              | \$ 5.67                             | \$ 6.41     | \$ (0.74)     |
| <b>Northeast:</b>                             |                                     |             |               |
| Operating income                              | \$ 5                                | \$ 289      | \$ (284)      |
| Throughput volumes (thousand barrels per day) | 556                                 | 574         | (18)          |
| Throughput margin per barrel (b)              | \$ 6.00                             | \$ 10.58    | \$ (4.58)     |
| Operating costs per barrel:                   |                                     |             |               |
| Refining operating expenses                   | \$ 4.50                             | \$ 3.77     | \$ 0.73       |
| Depreciation and amortization                 | 1.41                                | 1.22        | 0.19          |
| Total operating costs per barrel              | \$ 5.91                             | \$ 4.99     | \$ 0.92       |
| <b>West Coast:</b>                            |                                     |             |               |
| Operating income                              | \$ 11                               | \$ 313      | \$ (302)      |
| Throughput volumes (thousand barrels per day) | 261                                 | 295         | (34)          |
| Throughput margin per barrel (b)              | \$ 7.89                             | \$ 17.56    | \$ (9.67)     |
| Operating costs per barrel:                   |                                     |             |               |
| Refining operating expenses                   | \$ 5.56                             | \$ 4.38     | \$ 1.18       |
| Depreciation and amortization                 | 1.87                                | 1.41        | 0.46          |
| Total operating costs per barrel              | \$ 7.43                             | \$ 5.79     | \$ 1.64       |

See the footnote references on page 32.

**Table of Contents*****Average Market Reference Prices and Differentials (e)***  
***(dollars per barrel)***

|  | <b>Three Months Ended March 31,</b> |             |               |
|--|-------------------------------------|-------------|---------------|
|  | <b>2008</b>                         | <b>2007</b> | <b>Change</b> |
| <b>Feedstocks:</b>                             |                                     |             |               |
| West Texas Intermediate (WTI) crude oil        | \$ 97.94                            | \$ 58.00    | \$ 39.94      |
| WTI less sour crude oil at U.S. Gulf Coast (f) | 5.84                                | 5.92        | (0.08)        |
| WTI less Mars crude oil                        | 6.97                                | 4.91        | 2.06          |
| WTI less Alaska North Slope (ANS) crude oil    | 1.32                                | 2.30        | (0.98)        |
| WTI less Maya crude oil                        | 16.81                               | 12.63       | 4.18          |
| <b>Products:</b>                               |                                     |             |               |
| <b>U.S. Gulf Coast:</b>                        |                                     |             |               |
| Conventional 87 gasoline less WTI              | 4.23                                | 10.22       | (5.99)        |
| No. 2 fuel oil less WTI                        | 15.20                               | 9.82        | 5.38          |
| Ultra-low-sulfur diesel less WTI               | 20.37                               | 17.36       | 3.01          |
| Propylene less WTI                             | (0.77)                              | 16.21       | (16.98)       |
| <b>U.S. Mid-Continent:</b>                     |                                     |             |               |
| Conventional 87 gasoline less WTI              | 4.97                                | 12.12       | (7.15)        |
| Low-sulfur diesel less WTI                     | 20.92                               | 20.33       | 0.59          |
| <b>U.S. Northeast:</b>                         |                                     |             |               |
| Conventional 87 gasoline less WTI              | 3.07                                | 12.01       | (8.94)        |
| No. 2 fuel oil less WTI                        | 17.76                               | 11.35       | 6.41          |
| Lube oils less WTI                             | 32.29                               | 63.80       | (31.51)       |
| <b>U.S. West Coast:</b>                        |                                     |             |               |
| CARBOB 87 gasoline less ANS                    | 10.36                               | 29.98       | (19.62)       |
| CARB diesel less ANS                           | 21.27                               | 26.54       | (5.27)        |

The following notes relate to references on pages 29 through 32.

- (a) Effective July 1, 2007, we sold our Lima Refinery to Husky Refining Company (Husky), a wholly owned subsidiary of Husky Energy Inc. Therefore, the results of operations of the Lima Refinery for the three months ended March 31, 2007 are reported as discontinued operations, and all refining operating highlights, both consolidated and for the Mid-Continent region, exclude the Lima Refinery for the three months ended March 31, 2007.
- (b) Throughput margin per barrel represents operating revenues less cost of sales divided by throughput volumes.
- (c) Other products primarily include gas oils, No. 6 fuel oil, petroleum coke, and asphalt.
- (d) The regions reflected herein contain the following refineries: the Gulf Coast refining region includes the Corpus Christi East, Corpus Christi West, Texas City, Houston, Three Rivers, Krotz Springs, St. Charles, Aruba, and Port Arthur Refineries; the Mid-Continent refining region includes the McKee, Ardmore, and Memphis Refineries; the Northeast refining region includes the Quebec City, Paulsboro, and Delaware City Refineries; and the West Coast refining region includes the Benicia and Wilmington Refineries.
- (e) The average market reference prices and differentials, with the exception of the propylene and lube oil differentials, are based on posted prices from Platts Oilgram. The propylene differential is based on posted propylene prices in Chemical Market Associates, Inc. and the lube oil differential is based on Exxon Mobil Corporation postings provided by Independent Commodity Information Services London Oil Reports. The average market reference prices and differentials are presented to provide users of the consolidated financial statements with economic indicators that significantly affect our operations and profitability.

- (f) The market reference differential for sour crude oil is based on 50% Arab Medium and 50% Arab Light posted prices.

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**General**

Operating revenues increased 49% for the first quarter of 2008 compared to the first quarter of 2007 primarily as a result of higher refined product prices between the two periods. Operating income of \$472 million and income from continuing operations of \$261 million for the three months ended March 31, 2008 decreased 72% and 76%, respectively, from the corresponding amounts in the first quarter of 2007 primarily due to a \$1.2 billion decrease in refining segment operating income discussed below. The refining segment operating income and income from continuing operations for the three months ended March 31, 2007 exclude the operations of the Lima Refinery, which are classified as discontinued operations due to our sale of that refinery effective July 1, 2007 as discussed in Note 3 of Condensed Notes to Consolidated Financial Statements.

**Refining**

Operating income for our refining segment decreased from \$1.8 billion for the first quarter of 2007 to \$568 million for the first quarter of 2008, resulting from a 30% decrease in throughput margin per barrel, an 18% increase in refining operating expenses (including depreciation and amortization expense), and a 5% decline in throughput volumes. Total refining throughput margins for the first quarter of 2008 compared to the first quarter of 2007 were impacted by the following factors:

Gasoline margins decreased significantly in all of our refining regions in the first quarter of 2008 compared to the margins in the first quarter of 2007. The decline in gasoline margins for the first quarter of 2008 was primarily due to a significant increase in the cost of crude oil and other feedstocks combined with a decrease in demand and an increase in gasoline inventory levels.

Margins on various secondary refined products such as asphalt, fuel oils, propylene, and petroleum coke declined significantly from the first quarter of 2007 to the first quarter of 2008 as prices for these products did not increase in proportion to the large increase in the costs of the feedstocks used to produce them.

Distillate margins in the first quarter of 2008 increased in most of our refining regions from the margins in the first quarter of 2007. The increase in distillate margins was primarily due to tight supplies combined with continued strong global demand.

Medium and heavy sour crude oil feedstock differentials to WTI crude oil during the first quarter of 2008 remained wide and were wider than the differentials in the first quarter of 2007. These favorable differentials were attributable to continued ample supplies of sour crude oils and heavy sour residual fuel oils on the world market. Differentials on sour crude oil feedstocks also continued to benefit from increased demand for sweet crude oil resulting from lower sulfur specifications for gasoline and diesel.

Throughput volumes decreased 138,000 barrels per day during the first quarter of 2008 compared to the first quarter of 2007 primarily due to the fire at our Aruba Refinery discussed in Note 13 of Condensed Notes to Consolidated Financial Statements as well as downtime for maintenance at our Port Arthur Refinery.

Throughput margin for the first quarter of 2008 includes approximately \$100 million related to the McKee Refinery business interruption settlement discussed in Note 13 of Condensed Notes to Consolidated Financial Statements.

Refining operating expenses, excluding depreciation and amortization expense, were 19% higher for the quarter ended March 31, 2008 compared to the quarter ended March 31, 2007 primarily due to increases in energy costs, maintenance expense, and outside services. Refining depreciation and amortization

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expense increased 13% from the first quarter of 2007 to the first quarter of 2008 primarily due to the implementation of new capital projects and increased turnaround and catalyst amortization.

**Retail**

Retail operating income of \$50 million for the quarter ended March 31, 2008 decreased by approximately 6% compared to the \$53 million reported for the quarter ended March 31, 2007 as increases in selling expenses and depreciation and amortization expense more than offset somewhat higher margins from fuel sales in Canada and in-store sales.

**Corporate Expenses and Other**

General and administrative expenses decreased \$10 million from the first quarter of 2007 to the first quarter of 2008 due to nonrecurring executive retirement expenses incurred in the first quarter of 2007 and lower variable compensation expenses, partially offset by an increase in certain environmental expenses.

Other income, net for the first quarter of 2008 includes a \$14 million gain on the redemption of our 9.5% senior notes as discussed in Note 5 of Condensed Notes to Consolidated Financial Statements.

Interest and debt expense increased from the first quarter of 2007 to the first quarter of 2008 due mainly to the issuance of \$2.25 billion of notes in June 2007 to fund our accelerated share repurchase program and reduced capitalized interest resulting mainly from a reduced balance of capital projects under construction, partially offset by the effect of debt repayments during 2007 and the first quarter of 2008.

Income tax expense decreased \$398 million from the first quarter of 2007 to the first quarter of 2008 mainly as a result of lower operating income.

Income from discontinued operations for the three months ended March 31, 2007 represents net income from the operations of the Lima Refinery prior to its sale effective July 1, 2007.

**OUTLOOK**

Based on current forward market indicators, our outlook for refined product margins for the remainder of 2008 is mixed. With respect to the gasoline market, we expect the high price of crude oil and other feedstocks to continue to unfavorably impact gasoline margins. However, gasoline margins are expected to improve from first quarter levels as demand is anticipated to improve as the summer driving season approaches. In addition, we expect favorable diesel margins to continue, which should provide an incentive to refiners to maximize diesel production, thereby limiting gasoline supplies.

Our outlook for on-road diesel margins is favorable as on-road diesel demand globally continues to be good and on-road diesel inventory levels in 2008 are below 2007 levels on a days-of-supply basis. As a result, we expect on-road diesel margins to remain strong. Exports of distillate to South America and Europe are also keeping U.S. supplies tight.

In regard to feedstocks, sour crude oil differentials remained wide in April and are expected to remain favorable during 2008. Residual fuel oil prices have not increased as much as crude oil prices, which should support wider differentials for sour crude oil since complex refiners can substitute residual fuel oil for a portion of their sour crude oil requirements if residual fuel oil becomes more economic to process than crude oil. In addition, expected new supplies of medium sour crude oil from the Gulf of Mexico in 2008 should contribute to continuing wide sour crude oil differentials.



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Regarding operations in the second quarter, we expect to resume full operation of the Aruba Refinery and complete the scheduled maintenance on the coker drums at our Port Arthur Refinery that began in the first quarter, after which throughput volumes in the Gulf Coast region should return to normal levels. Our turnaround schedule for the second quarter is relatively light, which should benefit our results of operations during the quarter.

***LIQUIDITY AND CAPITAL RESOURCES******Cash Flows for the Three Months Ended March 31, 2008 and 2007***

Net cash provided by operating activities for the three months ended March 31, 2008 was \$628 million compared to \$1.9 billion for the three months ended March 31, 2007. The decrease in cash generated from operating activities was primarily due to the decrease in net income discussed above under Results of Operations, and a \$349 million decrease from an unfavorable change in working capital between the periods. Changes in cash provided by or used for working capital during the first three months of 2008 and 2007 are shown in Note 8 of Condensed Notes to Consolidated Financial Statements. Working capital in the first quarter of 2008 was primarily impacted by decreases in receivables and accounts payable due to (i) the termination in the first quarter of 2008 of certain agreements related to the sale of the Lima Refinery to Husky, (ii) a reduction in throughput and sales volumes mainly due to downtime at certain of our refineries, and (iii) delayed receivable collections at year-end 2007. In addition, income taxes payable decreased mainly due to \$414 million of income tax payments in the first quarter of 2008.

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.

The net cash generated from operating activities during the first three months of 2008, combined with \$1.0 billion of available cash on hand, were used mainly to:

- fund \$640 million of capital expenditures and deferred turnaround and catalyst costs;
- make an early redemption of our 9.5% senior notes for \$367 million and scheduled long-term note repayments of \$7 million;
- purchase 8.8 million shares of our common stock at a cost of \$518 million;
- fund a \$25 million contingent earn-out payment in connection with the acquisition of the St. Charles Refinery and a \$57 million acquisition primarily of an interest in a refined product pipeline; and
- pay common stock dividends of \$64 million.

The net cash generated from operating activities during the first three months of 2007, combined with a \$63 million benefit from tax deductions in excess of recognized stock-based compensation cost and \$37 million of proceeds from the issuance of common stock related to our employee benefit plans, were used mainly to:

- fund \$680 million of capital expenditures and deferred turnaround and catalyst costs;
- purchase 15.6 million shares of our common stock at a cost of \$904 million;
- redeem our 9.25% senior notes for \$183 million;
- fund a \$50 million contingent earn-out payment in connection with the acquisition of the St. Charles Refinery;
- pay common stock dividends of \$73 million; and
- increase available cash on hand by \$106 million.

**Table of Contents****Capital Investments**

During the three months ended March 31, 2008, we expended \$537 million for capital expenditures and \$103 million for deferred turnaround and catalyst costs. Capital expenditures for the three months ended March 31, 2008 included \$127 million of costs related to environmental projects.

In connection with our acquisition of the St. Charles Refinery in 2003, the seller was entitled to receive payments in any of the seven years following this acquisition if certain average refining margins during any of those years exceeded a specified level. Any payments due under this earn-out arrangement were limited based on annual and aggregate limits. In January 2008, we made a \$25 million earn-out payment related to the St. Charles Refinery, which was the final payment based on the aggregate limitation under that agreement. Subsequent to this payment, we have no further commitments with respect to contingent earn-out agreements.

For 2008, we expect to incur approximately \$4.2 billion for capital investments, including approximately \$3.7 billion for capital expenditures (approximately \$560 million of which is for environmental projects) and approximately \$500 million for deferred turnaround and catalyst costs. The capital expenditure estimate excludes expenditures related to the earn-out contingency agreement discussed above and strategic acquisitions. We continuously evaluate our capital budget and make changes as economic conditions warrant.

**Contractual Obligations**

As of March 31, 2008, our contractual obligations included long-term debt, capital lease obligations, operating leases, purchase obligations, and other long-term liabilities. On February 1, 2008, we redeemed our 9.50% senior notes for \$367 million, or 104.750% of stated value. 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 material changes outside the ordinary course of our business in capital lease obligations, operating leases, purchase obligations, or other long-term liabilities.

Our agreements do not have rating agency triggers that would automatically require us to post additional collateral. However, in the event of certain downgrades of our senior unsecured debt to below investment grade ratings by Moody's Investors Service and Standard & Poor's Ratings Services, the cost of borrowings under some of our bank credit facilities and other arrangements would increase. As of March 31, 2008, all of our ratings on our senior unsecured debt are at or above investment grade level as follows:

| <b>Rating Agency</b>               | <b>Rating</b>                   |
|------------------------------------|---------------------------------|
| Standard & Poor's Ratings Services | BBB (stable outlook)            |
| Moody's Investors Service          | Baa3 (under review for upgrade) |
| Fitch Ratings                      | BBB (stable outlook)            |

**Other Commercial Commitments**

As of March 31, 2008, our committed lines of credit included:

|                                    | <b>Borrowing<br/>Capacity</b> | <b>Expiration</b> |
|------------------------------------|-------------------------------|-------------------|
| Revolving credit facility          | \$2.5 billion                 | November 2012     |
| Canadian revolving credit facility | Cdn. \$115 million            | December 2012     |

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As of March 31, 2008, we had \$882 million of letters of credit outstanding under our uncommitted short-term bank credit facilities and \$669 million of letters of credit outstanding under our committed revolving credit facility. Under our Canadian committed revolving credit facility, we had Cdn. \$11 million of letters of credit outstanding as of March 31, 2008. These letters of credit expire during 2008 and 2009.

***Stock Purchase Programs***

During the first quarter of 2008, we purchased 8.8 million shares of our common stock at a cost of \$518 million in connection with the administration of our employee benefit plans and the \$6 billion common stock purchase program authorized by our board of directors in April 2007.

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.

***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 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.

***Other***

In April 2008, we made a \$20 million contribution to our qualified pension plans. We expect to contribute a total of approximately \$100 million to our qualified pension plans during 2008.

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.

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

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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.

On May 8, 2008, we entered into an agreement to sell our refinery in Krotz Springs, Louisiana to Alon USA Energy Inc. The sales price is \$333 million, plus an amount equal to net working capital at the refinery as of the closing date of the sale, which is expected to occur early in the third quarter of 2008. The sales agreement also includes an earn-out provision under which we will receive additional proceeds if certain average refining margins during the next three years exceed specified levels. Net proceeds from the sale exceed the carrying amount of the net assets being sold. The sale is subject to the receipt of required regulatory approvals.

In November 2007, January 2008, and March 2008, we announced plans to explore strategic alternatives related to our Aruba Refinery, Memphis Refinery, and Ardmore Refinery, respectively. We expect to complete these strategic evaluations, which may include the sale of these assets, later this year.

We are subject to extensive federal, state, and local environmental laws and regulations, including those relating to the discharge of materials into the environment, waste management, pollution prevention measures, greenhouse gas emissions, and characteristics and composition of gasolines and distillates. Because environmental laws and regulations are becoming more complex and stringent and new environmental laws and regulations are continuously being enacted or proposed, the level of future expenditures required for environmental matters could increase in the future. In addition, any major upgrades in any of our refineries could require material additional expenditures to comply with environmental laws and regulations.

We believe that we have sufficient funds from operations and, to the extent necessary, from the public and private capital markets and bank markets, to fund our ongoing operating requirements. We expect that, to the extent necessary, we can raise additional funds from time to time through equity or debt financings. However, there can be no assurances regarding the availability of any future financings or whether such financings can be made available on terms that are acceptable to us.

***OFF-BALANCE SHEET ARRANGEMENTS***

***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.

***CRITICAL ACCOUNTING POLICIES***

The preparation of financial statements in accordance with United States generally accepted accounting principles requires 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. Our critical accounting policies are disclosed in our annual report on Form 10-K for the year ended December 31, 2007.

As discussed in Note 2 of Condensed Notes to Consolidated Financial Statements, certain new financial accounting pronouncements have been issued which either have already been reflected in the accompanying consolidated financial statements, or will become effective for our financial statements at various dates in the future.

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**Item 3. Quantitative and Qualitative Disclosures About Market Risk**

***COMMODITY PRICE RISK***

The following tables provide information about our derivative commodity instruments as of March 31, 2008 and December 31, 2007 (dollars in millions, except for the weighted-average pay and receive prices as described below), including:

**Fair Value Hedges** - Fair value hedges are used to hedge our recognized refining inventories (which had a carrying amount of \$4.4 billion and \$3.9 billion as of March 31, 2008 and December 31, 2007, respectively, and a fair value of \$11.5 billion and \$10.1 billion as of March 31, 2008 and December 31, 2007, respectively) and our unrecognized firm commitments (i.e., binding agreements to purchase inventories in the future).

**Cash Flow Hedges** - Cash flow hedges are used to hedge our forecasted feedstock and product purchases, refined product sales, and natural gas purchases.

**Economic Hedges** - Economic hedges are hedges not designated as fair value or cash flow hedges that are used to:

- manage price volatility in refinery feedstock and refined product inventories, and
- manage price volatility in forecasted feedstock and product purchases, refined product sales, and natural gas purchases.

**Trading Activities** These represent derivative commodity instruments held or issued for trading purposes.

The gain or loss on a derivative instrument designated and qualifying as a fair value hedge and the offsetting loss or gain on the hedged item are recognized currently in income in the same period. The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedge is initially reported as a component of other comprehensive income and is then recorded in income in the period or periods during which the hedged forecasted transaction affects income. The ineffective portion of the gain or loss on the cash flow derivative instrument, if any, is recognized in income as incurred. For our economic hedges and for derivative instruments entered into by us for trading purposes, the derivative instrument is recorded at fair value and changes in the fair value of the derivative instrument are recognized currently in income.

The following tables include only open positions at the end of the reporting period, and therefore do not include amounts related to closed cash flow hedges for which the gain or loss remains in accumulated other comprehensive income pending consummation of the forecasted transactions.

Contract volumes are presented in thousands of barrels (for crude oil and refined products) or in billions of British thermal units (for natural gas). The weighted-average pay and receive prices represent amounts per barrel (for crude oil and refined products) or amounts per million British thermal units (for natural gas). Volumes shown for swaps represent notional volumes, which are used to calculate amounts due under the agreements. For futures, the contract value represents the contract price of either the long or short position multiplied by the derivative contract volume, while the market value amount represents the period-end market price of the commodity being hedged multiplied by the derivative contract volume. The pre-tax fair value for futures, swaps, and options represents the fair value of the derivative contract. The pre-tax fair value for swaps represents the excess of the receive price over the pay price multiplied by the notional contract volumes. For futures and options, the pre-tax fair value represents (i) the excess of the market value amount over the contract amount for long positions, or (ii) the excess of the contract amount over the market value amount for short positions. Additionally, for futures and options, the weighted-average pay price represents the contract price for long positions and the weighted-average

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receive price represents the contract price for short positions. The weighted-average pay price and weighted-average receive price for options represents their strike price.

|                                       |                  |                   | March 31, 2008        |                |              |                    |
|---------------------------------------|------------------|-------------------|-----------------------|----------------|--------------|--------------------|
|                                       | Contract Volumes | Wtd Avg Pay Price | Wtd Avg Receive Price | Contract Value | Market Value | Pre-tax Fair Value |
| <b><u>Fair Value Hedges:</u></b>      |                  |                   |                       |                |              |                    |
| <b>Futures long:</b>                  |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 12,316           | \$ 102.62         | N/A                   | \$ 1,264       | \$ 1,250     | \$ (14)            |
| <b>Futures short:</b>                 |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 21,543           | N/A               | \$ 103.92             | 2,239          | 2,185        | 54                 |
| <b><u>Cash Flow Hedges:</u></b>       |                  |                   |                       |                |              |                    |
| <b>Swaps long:</b>                    |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 12,775           | 96.56             | 99.49                 | N/A            | 37           | 37                 |
| <b>Swaps short:</b>                   |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 12,775           | 120.97            | 112.67                | N/A            | (106)        | (106)              |
| <b>Futures long:</b>                  |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 2,002            | 104.76            | N/A                   | 210            | 203          | (7)                |
| <b>Futures short:</b>                 |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 780              | N/A               | 96.19                 | 75             | 79           | (4)                |
| <b><u>Economic Hedges:</u></b>        |                  |                   |                       |                |              |                    |
| <b>Swaps long:</b>                    |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 9,347            | 27.45             | 26.58                 | N/A            | (8)          | (8)                |
| <b>Swaps short:</b>                   |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 5,308            | 48.16             | 49.62                 | N/A            | 8            | 8                  |
| <b>Futures long:</b>                  |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 31,306           | 107.31            | N/A                   | 3,359          | 3,371        | 12                 |
| 2009 (crude oil and refined products) | 2                | 102.67            | N/A                   | -              | -            | -                  |
| <b>Futures short:</b>                 |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 29,056           | N/A               | 105.48                | 3,065          | 3,097        | (32)               |
| <b>Options long:</b>                  |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 19               | 46.73             | N/A                   | -              | -            | -                  |
| <b><u>Trading Activities:</u></b>     |                  |                   |                       |                |              |                    |
| <b>Swaps long:</b>                    |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 14,927           | 22.49             | 23.69                 | N/A            | 18           | 18                 |
| <b>Swaps short:</b>                   |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 15,013           | 23.80             | 22.31                 | N/A            | (22)         | (22)               |
| <b>Futures long:</b>                  |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 19,468           | 108.75            | N/A                   | 2,117          | 2,157        | 40                 |
| 2009 (crude oil and refined products) | 829              | 94.69             | N/A                   | 78             | 78           | -                  |
| 2008 (natural gas)                    | 50               | 10.06             | N/A                   | 1              | 1            | -                  |
| <b>Futures short:</b>                 |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products) | 19,408           | N/A               | 109.12                | 2,118          | 2,146        | (28)               |
| 2009 (crude oil and refined products) | 829              | N/A               | 92.23                 | 76             | 78           | (2)                |
| <b>Options short:</b>                 |                  |                   |                       |                |              |                    |

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|   |    |     |       |   |   |                |
|---|----|-----|-------|---|---|----------------|
| 2008 (crude oil and refined products)             | 15 | N/A | 47.48 | - | - | -              |
| <b>Total pre-tax fair value of open positions</b> |    |     |       |   |   | <b>\$ (54)</b> |

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|   |                  |                   | December 31, 2007     |                |              |                    |
|---|------------------|-------------------|-----------------------|----------------|--------------|--------------------|
|   | Contract Volumes | Wtd Avg Pay Price | Wtd Avg Receive Price | Contract Value | Market Value | Pre-tax Fair Value |
| <b><u>Fair Value Hedges:</u></b>                  |                  |                   |                       |                |              |                    |
| <b>Futures - long:</b>                            |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 68,873           | \$ 97.69          | N/A                   | \$ 6,728       | \$ 6,961     | \$ 233             |
| <b>Futures - short:</b>                           |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 79,188           | N/A               | \$ 96.89              | 7,673          | 8,005        | (332)              |
| <b><u>Cash Flow Hedges:</u></b>                   |                  |                   |                       |                |              |                    |
| <b>Swaps - long:</b>                              |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 18,175           | 81.44             | 98.50                 | N/A            | 310          | 310                |
| <b>Swaps - short:</b>                             |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 18,175           | 102.55            | 86.25                 | N/A            | (296)        | (296)              |
| <b>Futures - long:</b>                            |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 80,960           | 103.50            | N/A                   | 8,379          | 8,596        | 217                |
| <b>Futures - short:</b>                           |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 73,735           | N/A               | 103.62                | 7,640          | 7,826        | (186)              |
| <b><u>Economic Hedges:</u></b>                    |                  |                   |                       |                |              |                    |
| <b>Swaps - long:</b>                              |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 12,012           | 33.16             | 39.48                 | N/A            | 76           | 76                 |
| <b>Swaps - short:</b>                             |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 7,397            | 63.91             | 54.25                 | N/A            | (71)         | (71)               |
| <b>Futures - long:</b>                            |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 77,902           | 96.20             | N/A                   | 7,494          | 7,802        | 308                |
| <b>Futures - short:</b>                           |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 76,426           | N/A               | 96.18                 | 7,351          | 7,663        | (312)              |
| <b>Options - long:</b>                            |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 89               | 47.72             | N/A                   | -              | 1            | 1                  |
| <b><u>Trading Activities:</u></b>                 |                  |                   |                       |                |              |                    |
| <b>Swaps - long:</b>                              |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 14,677           | 11.77             | 12.98                 | N/A            | 18           | 18                 |
| <b>Swaps - short:</b>                             |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 15,952           | 12.47             | 11.56                 | N/A            | (15)         | (15)               |
| <b>Futures - long:</b>                            |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 28,801           | 98.01             | N/A                   | 2,823          | 2,923        | 100                |
| <b>Futures - short:</b>                           |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 28,766           | N/A               | 98.20                 | 2,824          | 2,920        | (96)               |
| <b>Options - short:</b>                           |                  |                   |                       |                |              |                    |
| 2008 (crude oil and refined products)             | 66               | N/A               | 49.00                 | 1              | 1            | -                  |
| <b>Total pre-tax fair value of open positions</b> |                  |                   |                       |                |              | \$ (45)            |





**Table of Contents****INTEREST RATE RISK**

The following table provides information about our long-term debt instruments (dollars in millions), the fair value of which is sensitive to changes in interest rates. Principal cash flows and related weighted-average interest rates by expected maturity dates are presented. We had no interest rate derivative instruments outstanding as of March 31, 2008 and December 31, 2007.

|                        | March 31, 2008          |        |       |        |        |             | Total    | Fair Value |
|------------------------|-------------------------|--------|-------|--------|--------|-------------|----------|------------|
|                        | Expected Maturity Dates |        |       |        |        |             |          |            |
|                        | 2008                    | 2009   | 2010  | 2011   | 2012   | There-after |          |            |
| <b>Long-term Debt:</b> |                         |        |       |        |        |             |          |            |
| Fixed rate             | \$ -                    | \$ 209 | \$ 33 | \$ 418 | \$ 759 | \$ 5,085    | \$ 6,504 | \$ 6,636   |
| Average interest rate  | -                       | 3.6%   | 6.8%  | 6.4%   | 6.9%   | 6.7%        | 6.6%     |            |

|                        | December 31, 2007       |        |       |        |        |             | Total    | Fair Value |
|------------------------|-------------------------|--------|-------|--------|--------|-------------|----------|------------|
|                        | Expected Maturity Dates |        |       |        |        |             |          |            |
|                        | 2008                    | 2009   | 2010  | 2011   | 2012   | There-after |          |            |
| <b>Long-term Debt:</b> |                         |        |       |        |        |             |          |            |
| Fixed rate             | \$ 356                  | \$ 209 | \$ 33 | \$ 418 | \$ 759 | \$ 5,086    | \$ 6,861 | \$ 7,109   |
| Average interest rate  | 9.4%                    | 3.6%   | 6.8%  | 6.4%   | 6.9%   | 6.7%        | 6.8%     |            |

**FOREIGN CURRENCY RISK**

As of March 31, 2008, we had commitments to purchase \$237 million of U.S. dollars. Our market risk was minimal on these contracts, as they matured on or before April 18, 2008, resulting in a \$3 million loss in the second quarter of 2008.

**Item 4. Controls and Procedures.***(a) Evaluation of disclosure controls and procedures.*

Our management has evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report, and has concluded that our disclosure controls and procedures were operating effectively as of March 31, 2008.

*(b) Changes in internal control over financial reporting.*

There has been no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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**PART II OTHER INFORMATION**

**Item 1. Legal Proceedings.**

The information below describes new proceedings or material developments in proceedings that we previously reported in our annual report on Form 10-K for the year ended December 31, 2007.

***Litigation***

For the legal proceedings listed below, we hereby incorporate by reference into this Item our disclosures made in Part I, Item 1 of this Report included in Note 13 of Condensed Notes to Consolidated Financial Statements under the caption *Litigation*.

*MTBE Litigation*

*Retail Fuel Temperature Litigation*

*Rosolowski*

*Other Litigation*

***Environmental Enforcement Matters***

While it is not possible to predict the outcome of the following environmental proceedings, if any one or more of them were decided against us, we believe that there would be no material effect on our consolidated financial position or results of operations. We are reporting these proceedings to comply with SEC regulations, which require us to disclose certain information about proceedings arising under federal, state, or local provisions regulating the discharge of materials into the environment or protecting the environment if we reasonably believe that such proceedings will result in monetary sanctions of \$100,000 or more.

*New Jersey Department of Environmental Protection (NJDEP)* (Paulsboro Refinery) (this matter was last reported in our Form 10-K for the year ended December 31, 2007). We were subject to 17 air-related Administrative Order and Notice of Civil Administrative Penalty Assessments (Notices) issued by the NJDEP in 2005 and 2006, and one Notice issued in March 2007, relating to our Paulsboro Refinery. In the first quarter of 2008, we entered into a comprehensive settlement with the NJDEP to resolve these matters.

*Texas Commission on Environmental Quality (TCEQ)* (McKee Refinery) (this matter was last reported in our Form 10-K for the year ended December 31, 2007). In the first quarter of 2008, we settled three notices of enforcement from the TCEQ pertaining to alleged violations of state and federal air regulations at our McKee Refinery.

*TCEQ* (McKee Refinery). In March 2008, we received a proposed Agreed Order from the TCEQ for \$101,386 to resolve nine alleged violations of air regulations at our McKee Refinery. We are currently in settlement discussions with the TCEQ to resolve this matter.

**Item 1A. Risk Factors.**

There have been no material changes from the risk factors disclosed in the Risk Factors section of our annual report on Form 10-K for the year ended December 31, 2007.

**Table of Contents****Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.**

(a) *Unregistered Sales of Equity Securities.* Not applicable.

(b) *Use of Proceeds.* Not applicable.

(c) *Issuer Purchases of Equity Securities.* The following table discloses purchases of shares of our common stock made by us or on our behalf for the periods shown below.

| Period        | Total<br>Number of<br>Shares<br>Purchased | Average<br>Price<br>Paid per<br>Share | Total Number<br>of<br>Shares Not<br>Purchased as<br>Part<br>of Publicly<br>Announced<br>Plans<br>or Programs<br>(1) | Total Number<br>of<br>Shares<br>Purchased<br>as Part of<br>Publicly<br>Announced<br>Plans<br>or Programs | Maximum<br>Number (or<br>Approximate<br>Dollar<br>Value) of<br>Shares that<br>May Yet Be<br>Purchased<br>Under the<br>Plans or<br>Programs<br>(at month<br>end) (2) |
|---------------|---|---------------------------------------|---|--|---|
| January 2008  | 2,287,351                                 | \$70.04                               | 2,287,351   | -  | \$1.13 billion  |
| February 2008 | 2,658,336                                 | \$59.06                               | 1,284,336   | 1,374,000  | \$4.05 billion  |
| March 2008    | 3,871,228                                 | \$51.78                               | 1,228   | 3,870,000  | \$3.85 billion  |
| Total         | 8,816,915                                 | \$58.71                               | 3,572,915   | 5,244,000  | \$3.85 billion  |

(1) The shares reported in this column represent purchases settled in the first quarter of 2008 relating to (a) our purchases of shares in open-market transactions to meet our obligations under employee benefit plans, and (b) our purchases of shares from our employees and non-employee directors in connection with the exercise of stock options, the vesting of restricted stock, and other stock compensation transactions in accordance with the terms of our incentive compensation plans.

(2) On April 26, 2007, we publicly announced an increase in our common stock purchase program from \$2 billion to \$6 billion, as authorized by our board of directors on April 25, 2007. The \$6 billion common stock purchase program has no expiration date. On February 28, 2008, we announced that our board of directors approved a new \$3 billion common stock purchase program earlier that day. This program is in addition to the \$6 billion program. This new \$3 billion program has no expiration date.

**Item 6. Exhibits.**

| Exhibit No. | Description  |
|-------------|--|
| *12.01      | Statements of Computations of Ratios of Earnings to Fixed Charges and Ratios of Earnings to Fixed Charges and Preferred Stock Dividends. |
| *31.01      | Rule 13a-14(a) Certifications (under Section 302 of the Sarbanes-Oxley Act of 2002).   |
| *32.01      | Section 1350 Certifications (as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).                                      |

\* Filed herewith.

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**SIGNATURE**

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

**VALERO ENERGY CORPORATION**

(Registrant)

By: /s/ Michael S. Ciskowski  
Michael S. Ciskowski  
Executive Vice President and  
Chief Financial Officer  
(Duly Authorized Officer and Principal  
Financial and Accounting Officer)

Date: May 9, 2008