

VALERO ENERGY CORP/TX

Form 10-Q

August 08, 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 June 30, 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. (Check one):

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 July 31, 2008 was 523,159,876.

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

	<b>June 30, 2008 (Unaudited)</b>	<b>December 31, 2007</b>
<b>ASSETS</b>		
Current assets:		
Cash and temporary cash investments	\$ 1,644	\$ 2,464
Restricted cash	100	31
Receivables, net	7,721	7,691
Inventories	4,904	4,073
Deferred income taxes	388	247
Prepaid expenses and other	160	175
Assets held for sale	335	306
 Total current assets	 15,252	 14,987
 Property, plant and equipment, at cost	 26,768	 25,599
Accumulated depreciation	(4,493)	(4,039)
 Property, plant and equipment, net	 22,275	 21,560
 Intangible assets, net	 268	 290
Goodwill	4,039	4,019
Deferred charges and other assets, net	1,822	1,866
 Total assets	 \$ 43,656	 \$ 42,722
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	\$ 212	\$ 392
Accounts payable	10,963	9,587
Accrued expenses	447	500
Taxes other than income taxes	566	632
Income taxes payable	403	499
Deferred income taxes	247	293
Liabilities related to assets held for sale	10	11
 Total current liabilities	 12,848	 11,914

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Long-term debt and capital lease obligations, less current portion	6,263	6,470
Deferred income taxes	4,085	4,021
Other long-term liabilities	1,780	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	7,215	7,111
Treasury stock, at cost; 102,473,766 and 90,841,602 common shares	(6,733)	(6,097)
Retained earnings	17,765	16,914
Accumulated other comprehensive income	427	573
Total stockholders' equity	18,680	18,507
Total liabilities and stockholders' equity	\$ 43,656	\$ 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</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Operating revenues (1)	\$ 36,640	\$ 24,202	\$ 64,585	\$ 42,957
Costs and expenses:				
Cost of sales	33,673	19,310	59,342	34,820
Refining operating expenses	1,133	985	2,247	1,919
Retail selling expenses	190	200	378	371
General and administrative expenses	117	177	252	322
Depreciation and amortization expense	369	337	736	659
Total costs and expenses	35,482	21,009	62,955	38,091
Operating income	1,158	3,193	1,630	4,866
Other income, net	15	7	35	12
Interest and debt expense:				
Incurred	(107)	(110)	(223)	(199)
Capitalized	24	27	43	58
Income from continuing operations before income tax expense	1,090	3,117	1,485	4,737
Income tax expense	356	1,055	490	1,587
Income from continuing operations	734	2,062	995	3,150
Income from discontinued operations, net of income tax expense	-	187	-	243
Net income	\$ 734	\$ 2,249	\$ 995	\$ 3,393
Earnings per common share:				
Continuing operations	\$ 1.40	\$ 3.66	\$ 1.88	\$ 5.42
Discontinued operations	-	0.33	-	0.42
Total	\$ 1.40	\$ 3.99	\$ 1.88	\$ 5.84

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Weighted-average common shares outstanding (in millions)	526	563	529	581
Earnings per common share assuming dilution:				
Continuing operations	\$ 1.37	\$ 3.57	\$ 1.85	\$ 5.28
Discontinued operations	-	0.32	-	0.40
Total	\$ 1.37	\$ 3.89	\$ 1.85	\$ 5.68
Weighted-average common shares outstanding assuming dilution (in millions)	534	578	537	597
Dividends per common share	\$ 0.15	\$ 0.12	\$ 0.27	\$ 0.24
Supplemental information:				
(1) Includes excise taxes on sales by our U.S. retail system	\$ 204	\$ 203	\$ 398	\$ 399

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>Six Months Ended June 30,</b>	
	<b>2008</b>	<b>2007</b>
<b>Cash flows from operating activities:</b>		
Net income	\$ 995	\$ 3,393
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	736	675
Stock-based compensation expense	24	46
Deferred income tax expense (benefit)	(93)	153
Changes in current assets and current liabilities	189	60
Changes in deferred charges and credits and other operating activities, net	(49)	24
Net cash provided by operating activities	1,802	4,351
<b>Cash flows from investing activities:</b>		
Capital expenditures	(1,178)	(1,042)
Deferred turnaround and catalyst costs	(203)	(230)
(Investment) return of investment in Cameron Highway Oil Pipeline Company, net	12	(215)
Advance proceeds related to sale of assets	17	96
Contingent payments in connection with acquisitions	(25)	(75)
Minor acquisitions and other investing activities, net	(43)	15
Net cash used in investing activities	(1,420)	(1,451)
<b>Cash flows from financing activities:</b>		
Long-term notes:		
Borrowings	-	2,245
Repayments	(374)	(413)
Bank credit agreements:		
Borrowings	296	3,000
Repayments	(296)	(3,000)
Purchase of common stock for treasury	(700)	(4,181)
Issuance of common stock in connection with employee benefit plans	11	111
Benefit from tax deduction in excess of recognized stock-based compensation cost	13	215
Common stock dividends	(143)	(139)
Other financing activities	(2)	(21)
Net cash used in financing activities	(1,195)	(2,183)
Effect of foreign exchange rate changes on cash	(7)	29



<b>Net increase (decrease) in cash and temporary cash investments</b>	(820)	746
<b>Cash and temporary cash investments at beginning of period</b>	2,464	1,590
<b>Cash and temporary cash investments at end of period</b>	\$ 1,644	\$ 2,336

See Condensed Notes to Consolidated Financial Statements.

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

	Three Months Ended		Six Months Ended	
	June 30,		June 30,	
	2008	2007	2008	2007
Net income	\$ 734	\$ 2,249	\$ 995	\$ 3,393
Other comprehensive income (loss):				
Foreign currency translation adjustment, net of income tax expense of \$0, \$31, \$0, and \$31	15	141	(62)	161
Pension and other postretirement benefits net (gain) loss reclassified into income, net of income tax expense (benefit) of \$1, \$(1), \$1, and \$(2)	(1)	2	(1)	3
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, \$24, \$54, and \$47	(51)	(45)	(100)	(87)
Net (gain) loss reclassified into income, net of income tax expense (benefit) of \$(17), \$(2), \$(9), and \$4	32	4	17	(7)
Net loss on cash flow hedges	(19)	(41)	(83)	(94)
Other comprehensive income (loss)	(5)	102	(146)	70
Comprehensive income	\$ 729	\$ 2,351	\$ 849	\$ 3,463

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 our 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 and six months ended June 30, 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 and six months ended June 30, 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. As discussed in Note 3, the assets and liabilities related to the Krotz Springs Refinery, including inventory to be sold by our marketing and supply subsidiary associated with this transaction, have been reclassified as held for sale as of December 31, 2007.

See Note 3 for a discussion of the presentation in the statements of income of the results of operations of the Krotz Springs Refinery and the Lima Refinery, which were sold effective July 1, 2008 and July 1, 2007, respectively.

***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 assets and liabilities related to the Krotz Springs Refinery as held for sale as discussed above.

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

**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 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; 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

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

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

***FASB Statement No. 162***

In May 2008, the FASB issued Statement No. 162, The Hierarchy of Generally Accepted Accounting Principles. Statement No. 162 identifies the sources of accounting principles and the framework for selecting the principles used in the preparation of financial statements that are presented in conformity with GAAP. Statement No. 162 is effective 60 days following approval by the Securities and Exchange Commission (SEC) of the Public Company Accounting Oversight Board's amendments to AU Section 411, *The Meaning of Present Fairly in Conformity with Generally Accepted Accounting Principles*. The adoption of Statement No. 162 will not affect our financial position or results of operations.

***FSP No. EITF 03-6-1***

In June 2008, the FASB issued Staff Position No. EITF 03-6-1, Determining Whether Instruments Granted in Share-Based Payment Transactions Are Participating Securities (FSP No. EITF 03-6-1). FSP No. EITF 03-6-1 addresses whether instruments granted in share-based payment transactions are participating securities prior to vesting and, therefore, need to be included in the earnings allocation in computing earnings per share under the two-class method described in Statement No. 128. FSP No. EITF 03-6-1 is effective for fiscal years, and interim periods within those fiscal years, beginning on or after December 15, 2008; early adoption is not permitted. The adoption of FSP No. EITF 03-6-1 effective January 1, 2009 is not expected to materially affect our calculation of earnings per common share.

**3. DISPOSITIONS**

***Sale of Krotz Springs Refinery***

On May 8, 2008, we entered into an agreement to sell our refinery in Krotz Springs, Louisiana to Alon Refining Krotz Springs, Inc. (Alon), a subsidiary of Alon USA Energy, Inc. As a result, the assets and liabilities related to the Krotz Springs Refinery as of June 30, 2008 and December 31, 2007 have been presented in the consolidated balance sheets as assets held for sale and liabilities related to assets held for sale, respectively. The nature and significance of our post-closing participation in the offtake agreement described below represents a continuation of activities with the Krotz Springs Refinery for accounting purposes, and as such the results of operations related to the Krotz Springs Refinery have not been presented as discontinued operations in the consolidated statements of income for any of the periods presented.

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

Effective July 1, 2008, we consummated the sale of our Krotz Springs Refinery to Alon. Initial proceeds from the sale were \$333 million, plus \$143 million representing a preliminary working capital settlement related to the sale of inventory by our marketing and supply subsidiary. The working capital settlement is expected to be finalized within 90 days after the effective date of the sale. In addition to the cash consideration received, we also received contingent consideration in the form of a three-year earn-out agreement based on certain product margins, which had a fair value of approximately \$170 million as of July 1, 2008. We have hedged the risk of a decline in the referenced product margins subsequent to the acquisition date by entering into certain commodity derivative contracts.

In connection with the sale, we also entered into the following agreements with Alon:

an agreement to supply crude oil and other feedstocks to the Krotz Springs Refinery through September 30, 2008, unless terminated earlier by Alon;

an offtake agreement under which we will (i) purchase all refined products from the Krotz Springs Refinery for three months after the effective date of the sale, (ii) purchase certain products for an additional one to five years after the expiration of the initial three-month period of the agreement, and (iii) provide certain refined products to Alon that are not produced at the Krotz Springs Refinery for an initial term of 15 months and thereafter until terminated by either party; and

a transition services agreement under which we agreed to provide certain accounting and administrative services to Alon, with the services terminating by July 31, 2009.

Financial information related to the assets and liabilities sold is summarized as follows (in millions):

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Current assets (primarily inventory)	\$ 136	\$ 111
Property, plant and equipment, net	153	149
Goodwill	42	42
Deferred charges and other assets, net	4	4
 Assets held for sale	 \$ 335	 \$ 306
 Current liabilities	 \$ 10	 \$ 11
 Liabilities related to assets held for sale	 \$ 10	 \$ 11

***Sale 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 statements of income for the three and six months ended June 30, 2007 reflect 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 and six months ended June 30, 2007 was as follows (in millions):

	<b>Three Months Ended June 30, 2007</b>	<b>Six Months Ended June 30, 2007</b>
Operating revenues	\$ 1,288	\$ 2,231

Income before income tax expense	10	300	391
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**VALERO ENERGY CORPORATION AND SUBSIDIARIES**  
**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**

**4. INVENTORIES**

Inventories consisted of the following (in millions):

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Refinery feedstocks	\$ 2,349	\$ 1,701
Refined products and blendstocks	2,290	2,117
Convenience store merchandise	86	85
Materials and supplies	179	170
Inventories	<b>\$ 4,904</b>	<b>\$ 4,073</b>

Excluding the inventories sold to Alon as discussed in Note 3, as of June 30, 2008 and December 31, 2007, the replacement cost (market value) of LIFO inventories exceeded their LIFO carrying amounts by approximately \$10.4 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 six months ended June 30, 2008, we borrowed and repaid \$296 million under our revolving bank credit facility. As of June 30, 2008, we had no borrowings under our revolving credit facilities or our short-term uncommitted bank credit facilities.

In June 2008, we entered into a one-year committed revolving letter of credit facility under which we may obtain letters of credit of up to \$300 million to support certain of our crude oil purchases. We are being charged letter of credit issuance fees in connection with the letter of credit facility.

As of June 30, 2008, we had \$663 million of letters of credit outstanding under our uncommitted short-term bank credit facilities and \$898 million of letters of credit outstanding under our committed revolving credit facilities, excluding our Canadian facility. Under our Canadian committed revolving credit facility, we had Cdn. \$16 million of letters of credit outstanding as of June 30, 2008.

**6. STOCKHOLDERS EQUITY****Treasury Stock**

During the six months ended June 30, 2008 and 2007, we purchased 12.6 million and 61.9 million shares of our common stock at a cost of \$700 million and \$4.2 billion, respectively, in connection with the administration of our employee benefit plans and common stock purchase programs authorized by our board of directors. During the six months ended June 30, 2008, we issued 0.9 million shares from treasury at an average cost of \$67.08 per share, and for the six months ended June 30, 2007, we issued 11.4 million shares from treasury at an average cost of \$61.28 per share, for our employee benefit plans.



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

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 June 30, 2008, we had made no purchases of our common stock under the new \$3 billion program. As of June 30, 2008, we have approvals under these stock purchase programs to purchase approximately \$3.7 billion of our common stock.

**Common Stock Dividends**

On July 9, 2008, our board of directors declared a regular quarterly cash dividend of \$0.15 per common share payable on September 10, 2008 to holders of record at the close of business on August 6, 2008.

**7. EARNINGS PER COMMON SHARE**

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

	<b>Three Months Ended</b>		<b>Six Months Ended</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Earnings per common share from continuing operations:				
Income from continuing operations	\$ 734	\$ 2,062	\$ 995	\$ 3,150
Weighted-average common shares outstanding	526	563	529	581
Earnings per common share from continuing operations	\$ 1.40	\$ 3.66	\$ 1.88	\$ 5.42
Earnings per common share from continuing operations assuming dilution:				
Income from continuing operations	\$ 734	\$ 2,062	\$ 995	\$ 3,150
Weighted-average common shares outstanding	526	563	529	581
Effect of dilutive securities:				
Stock options	8	13	8	14
Performance awards and other benefit plans	-	1	-	1
Contingently issuable shares related to accelerated share repurchase program	-	1	-	1
Weighted-average common shares outstanding assuming dilution	534	578	537	597
Earnings per common share from continuing operations assuming dilution	\$ 1.37	\$ 3.57	\$ 1.85	\$ 5.28

Approximately 4 million outstanding stock options were not included in the computation of dilutive securities for the three and six months ended June 30, 2008 because the options' exercise prices were greater than the average market price of the common shares during the reporting period, and therefore the

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

effect of including such options would be anti-dilutive. There were no anti-dilutive stock options outstanding for the three and six months ended June 30, 2007.

**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>Six Months Ended June</b>	
	<b>2008</b>	<b>30,</b> <b>2007</b>
Decrease (increase) in current assets:		
Restricted cash	\$ (69)	\$ -
Receivables, net	(54)	(268)
Inventories	(865)	(638)
Income taxes receivable	-	32
Prepaid expenses and other	4	14
Increase (decrease) in current liabilities:		
Accounts payable	1,466	464
Accrued expenses	(144)	(71)
Taxes other than income taxes	(61)	3
Income taxes payable	(88)	524
Changes in current assets and current liabilities	\$ 189	\$ 60

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;

previously accrued capital expenditures, deferred turnaround and catalyst costs, and contingent earn-out payments, as well as advance proceeds related to the sale of assets, are reflected in investing activities in the consolidated statements of cash flows;

amounts accrued for common stock purchases in the open market that are not settled as of the balance sheet date are reflected in financing activities in the consolidated statements of cash flows when the purchases are settled and paid;

changes in assets held for sale and liabilities related to assets held for sale related to the Krotz Springs Refinery from December 31, 2007 to June 30, 2008 and the Lima Refinery from December 31, 2006 to June 30, 2007 are reflected in the line items 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.

There were no significant noncash investing or financing activities for the six months ended June 30, 2008 and 2007. 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



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

six months ended June 30, 2007. Cash provided by operating activities related to our discontinued Lima Refinery operations was \$260 million for the six months ended June 30, 2007. Cash used in investing activities related to the Lima Refinery was \$14 million for the six months ended June 30, 2007.

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

	<b>Six Months Ended June</b>	
	<b>30,</b>	
	<b>2008</b>	<b>2007</b>
Interest paid (net of amount capitalized)	\$ 199	\$ 139
Income taxes paid (net of tax refunds received)	659	811

**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. 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.

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

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 June 30, 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 June 30, 2008, we did not have any assets or liabilities that had fair values determined by Level 3 inputs.

	<b>Fair Value Measurements Using</b>			<b>Total as of June 30, 2008</b>
	<b>Quoted Prices in Active Markets  (Level 1)</b>	<b>Significant Other Observable Inputs  (Level 2)</b>	<b>Significant Unobservable Inputs  (Level 3)</b>	
<b>Assets:</b>				
Commodity derivative contracts	\$ 135	\$ -	\$ -	\$ 135
Nonqualified benefit plans	130	-	-	130
<b>Liabilities:</b>				
Commodity derivative contracts	-	142	-	142
Nonqualified benefit plans	38	-	-	38

The valuation methods used to measure our financial instruments at fair value are as follows:

Commodity derivative contracts, consisting primarily of exchange-traded futures and swaps, are measured at fair value using the market approach pursuant to the provisions of Statement No. 157. Exchange-traded futures are valued based on quoted prices from the exchange and are categorized in Level 1 of the fair value hierarchy. Swaps are priced using third-party broker quotes, industry pricing services, and exchange-traded curves, but since they have contractual terms that are not identical to exchange-traded futures instruments with a comparable market price, these financial instruments are categorized in Level 2 of the fair value hierarchy.

Nonqualified benefit plans are measured at fair value using a market approach based on quotations from national securities exchanges and are categorized in Level 1 of the fair value hierarchy.

Deposits of \$335 million in broker accounts covered by master netting arrangements are netted against the fair value of the commodity derivatives reflected in Level 1. Certain of our commodity derivative contracts under master netting arrangements include both asset and liability positions. Under the guidance of FASB Staff Position No. FIN 39-1,

Amendment of FASB Interpretation No. 39, we have elected to offset the fair value amounts recognized for multiple derivative instruments executed with the same counterparty, including the related cash collateral.

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

**10. PRICE RISK MANAGEMENT ACTIVITIES**

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

	<b>Three Months</b>		<b>Six Months Ended</b>	
	<b>Ended</b>		<b>June 30,</b>	
	<b>June 30,</b>		<b>June 30,</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
Fair value hedges	\$ -	\$ (1)	\$ 2	\$ (2)
Cash flow hedges	-	(7)	(10)	(6)

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 six months ended June 30, 2008, we recognized in other comprehensive income unrealized after-tax losses of \$100 million on certain cash flow hedges, primarily related to forward sales of distillates and associated forward purchases of crude oil, with \$66 million of cumulative after-tax losses on cash flow hedges remaining in accumulated other comprehensive income as of June 30, 2008. We expect that the deferred losses as of June 30, 2008 will be reclassified into cost of sales over the next 18 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 six months ended June 30, 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 June 30, 2008:</b>				
Operating revenues from external customers	\$ 33,625	\$ 3,015	\$ -	\$ 36,640
Intersegment revenues	2,367	-	-	2,367
Operating income (loss)	1,235	49	(126)	1,158
<b>Three months ended June 30, 2007:</b>				
Operating revenues from external customers	21,883	2,319	-	24,202
Intersegment revenues	1,654	-	-	1,654
Operating income (loss)	3,327	56	(190)	3,193
<b>Six months ended June 30, 2008:</b>				
Operating revenues from external customers	59,055	5,530	-	64,585
Intersegment revenues	4,267	-	-	4,267
Operating income (loss)	1,803	99	(272)	1,630
<b>Six months ended June 30, 2007:</b>				
Operating revenues from external customers	38,732	4,225	-	42,957
Intersegment revenues	2,963	-	-	2,963
Operating income (loss)	5,103	109	(346)	4,866
Total assets by reportable segment were as follows (in millions):				

	<b>June 30, 2008</b>	<b>December 31, 2007</b>
Refining	\$ 39,236	\$ 37,703
Retail	2,193	2,098
Corporate	2,227	2,921
Total consolidated assets	\$ 43,656	\$ 42,722

The entire balance of goodwill as of June 30, 2008 and December 31, 2007 has been included in the total assets of the refining reportable segment. Total assets related to the Krotz Springs Refinery have been included in the refining reportable segment for both periods presented.



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

**12. EMPLOYEE BENEFIT PLANS**

The components of net periodic benefit cost related to our defined benefit plans were as follows for the three and six months ended June 30, 2008 and 2007 (in millions):

	<b>Pension Plans</b>		<b>Other Postretirement Benefit Plans</b>	
	<b>2008</b>	<b>2007</b>	<b>2008</b>	<b>2007</b>
<b>Three months ended June 30:</b>				
Components of net periodic benefit cost:				
Service cost	\$ 24	\$ 24	\$ 4	\$ 4
Interest cost	19	17	7	6
Expected return on plan assets	(26)	(21)	-	-
Amortization of:				
Prior service cost (credit)	-	-	(3)	(2)
Net loss	1	3	1	1
Net periodic benefit cost before special charges	18	23	9	9
Charge for special termination benefits	-	7	-	1
Net periodic benefit cost	\$ 18	\$ 30	\$ 9	\$ 10
<b>Six months ended June 30:</b>				
Components of net periodic benefit cost:				
Service cost	\$ 47	\$ 48	\$ 7	\$ 7
Interest cost	38	35	14	13
Expected return on plan assets	(52)	(42)	-	-
Amortization of:				
Prior service cost (credit)	1	1	(5)	(5)
Net loss	1	5	2	3
Net periodic benefit cost before special charges	35	47	18	18
Charge for special termination benefits	-	7	-	1
Net periodic benefit cost	\$ 35	\$ 54	\$ 18	\$ 19

During the six months ended June 30, 2008, we contributed \$20 million to our qualified pension plans, and in July 2008, we made an additional \$80 million contribution to those plans. We do not expect to make any additional contributions to our qualified pension plans during 2008. There were no contributions made during the six months ended June 30, 2007.

**13. COMMITMENTS AND CONTINGENCIES*****Accounts Receivable Sales Facility***

As of December 31, 2007, we had an accounts receivable sales facility with a group of third-party entities and financial institutions to sell on a revolving basis up to \$1 billion of eligible trade receivables. The facility had a maturity date of August 2008. In June 2008, we amended our agreement to extend the maturity date to June 2009. As of June 30, 2008 and December 31, 2007, the amount of eligible receivables sold to the third parties was \$100 million.



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

***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 June 30, 2008, aggregate earn-out payments related to the St. Charles Refinery totaled \$175 million, which was the aggregate limit under that agreement. As of June 30, 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 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 on a monthly basis until the tax dispute is resolved through the Aruba proceedings. Amounts deposited under this escrow agreement, which totaled approximately \$70 million as of June 30, 2008, are 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. As of June 30, 2008, we had completed the repairs and resumed full operations of the refinery.

***Keystone Pipeline***

In July 2008, we entered into an agreement to participate as a prospective shipper on the 500,000 barrel-per-day expansion of the Keystone crude oil pipeline system, which is expected to be completed by 2012.

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

Once completed, the pipeline will enable crude oil to be transported from Western Canada to the U.S. Gulf Coast at Port Arthur, Texas. In addition to our commitment to ship crude oil through the pipeline, we have an option to acquire an equity interest in the Keystone partnerships. We have also secured commitments from several Canadian oil producers to sell to us heavy sour crude oil for shipment through the pipeline.

***Litigation***

***MTBE Litigation***

As of August 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 immaterial cash payment. We anticipate that a portion of our payment will be funded by third parties. In addition, we will commit to participate with other defendants in contingent future treatment of water supply wells under certain defined circumstances. The settlement will not become effective until it is approved by one federal and two state court judges, which we believe may occur in the third quarter of 2008. The federal judge approved the settlement on July 22, 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 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 the remaining 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 remaining 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 August 1, 2008, we were named in 21 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. In July 2008, plaintiffs filed a pleading attempting to name Valero and other petroleum companies as class representatives of defendant classes composed of their respective branded outlets, including retail outlets owned by other parties. 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 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 acquisition of Premcor Inc. 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 appealed the court's decision to vacate the \$120 million judgment and decertify the class. Plaintiffs' appeal was heard before the state appeals court in February 2008, and in June 2008, the state appeals court reversed the trial court's decision to decertify the class and set aside the judgment. The appeals court preserved our rights, and on August 4 we filed an appeal to the Illinois Supreme Court. While we believe that it is reasonably possible that we will prevail on the merits of this case, we have recorded a loss contingency liability with respect to this matter in accordance with Statement No. 5. We do not believe that the ultimate resolution of 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 June 30, 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 June 30, 2008**  
**(unaudited, in millions)**

	<b>Valero Energy Corporation</b>	<b>PRG</b>	<b>Other Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
<b>ASSETS</b>					
Current assets:					
Cash and temporary cash investments	\$ 858	\$ -	\$ 786	\$ -	\$ 1,644
Restricted cash	22	2	76	-	100
Receivables, net	-	93	7,628	-	7,721
Inventories	-	333	4,571	-	4,904
Deferred income taxes	-	-	388	-	388
Prepaid expenses and other	-	9	151	-	160
Assets held for sale	-	-	335	-	335
<b>Total current assets</b>	<b>880</b>	<b>437</b>	<b>13,935</b>	<b>-</b>	<b>15,252</b>
Property, plant and equipment, at cost	-	5,636	21,132	-	26,768
Accumulated depreciation	-	(398)	(4,095)	-	(4,493)
<b>Property, plant and equipment, net</b>	<b>-</b>	<b>5,238</b>	<b>17,037</b>	<b>-</b>	<b>22,275</b>
Intangible assets, net	-	-	268	-	268
Goodwill	-	1,836	2,203	-	4,039
Investment in Valero Energy affiliates	7,989	2,273	(19)	(10,243)	-
Long-term notes receivable from affiliates	16,037	-	-	(16,037)	-
Deferred income tax receivable	419	-	-	(419)	-
Deferred charges and other assets, net	389	116	1,317	-	1,822
<b>Total assets</b>	<b>\$ 25,714</b>	<b>\$ 9,900</b>	<b>\$ 34,741</b>	<b>\$ (26,699)</b>	<b>\$ 43,656</b>
<b>LIABILITIES AND STOCKHOLDERS EQUITY</b>					
Current liabilities:					
Current portion of long-term debt and capital lease obligations	\$ 208	\$ -	\$ 4	\$ -	\$ 212
Accounts payable	112	274	10,577	-	10,963
Accrued expenses	80	33	334	-	447
Taxes other than income taxes	-	17	549	-	566
Income taxes payable	262	66	75	-	403

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Deferred income taxes	247	-	-	-	247
Liabilities related to assets held for sale	-	-	10	-	10
Total current liabilities	909	390	11,549	-	12,848
Long-term debt and capital lease obligations, less current portion	5,325	900	38	-	6,263
Long-term notes payable to affiliates	-	7,177	8,860	(16,037)	-
Deferred income taxes	-	1,255	3,249	(419)	4,085
Other long-term liabilities	800	197	783	-	1,780
Stockholders' equity:					
Common stock	6	-	2	(2)	6
Additional paid-in capital	7,215	75	3,603	(3,678)	7,215
Treasury stock	(6,733)	-	-	-	(6,733)
Retained earnings (deficit)	17,765	(92)	6,726	(6,634)	17,765
Accumulated other comprehensive income (loss)	427	(2)	(69)	71	427
Total stockholders' equity	18,680	(19)	10,262	(10,243)	18,680
Total liabilities and stockholders' equity	\$ 25,714	\$ 9,900	\$ 34,741	\$ (26,699)	\$ 43,656



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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 Energy Corporation</b>	<b>PRG</b>	<b>Other Non- Guarantor 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	3,504	-	4,073
Deferred income taxes	-	-	247	-	247
Prepaid expenses and other	-	11	164	-	175
Assets held for sale	-	-	306	-	306
<b>Total current assets</b>	<b>1,438</b>	<b>701</b>	<b>12,848</b>	<b>-</b>	<b>14,987</b>
Property, plant and equipment, at cost	-	6,681	18,918	-	25,599
Accumulated depreciation	-	(420)	(3,619)	-	(4,039)
<b>Property, plant and equipment, net</b>	<b>-</b>	<b>6,261</b>	<b>15,299</b>	<b>-</b>	<b>21,560</b>
Intangible assets, net	-	2	288	-	290
Goodwill	-	1,816	2,203	-	4,019
Investment in Valero Energy affiliates	7,080	1,183	73	(8,336)	-
Long-term notes receivable from affiliates	17,321	-	-	(17,321)	-
Deferred charges and other assets, net	386	165	1,315	-	1,866
<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</b>					
<b>EQUITY</b>					
Current liabilities:					
Current portion of long-term debt and capital lease obligations	\$ 7	\$ 382	\$ 3	\$ -	\$ 392
Accounts payable	234	302	9,051	-	9,587
Accrued expenses	79	55	366	-	500
Taxes other than income taxes	-	25	607	-	632
Income taxes payable	227	115	157	-	499
Deferred income taxes	21	272	-	-	293
Liabilities related to assets held for sale	-	-	11	-	11

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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 June 30, 2008**  
**(unaudited, in millions)**

	<b>Valero Energy Corporation</b>	<b>PRG</b>	<b>Other Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Operating revenues	\$ -	\$ 8,065	\$ 36,073	\$ (7,498)	\$ 36,640
Costs and expenses:					
Cost of sales	-	7,849	33,322	(7,498)	33,673
Refining operating expenses	-	207	926	-	1,133
Retail selling expenses	-	-	190	-	190
General and administrative expenses	(2)	1	118	-	117
Depreciation and amortization expense	-	60	309	-	369
Total costs and expenses	(2)	8,117	34,865	(7,498)	35,482
Operating income (loss)	2	(52)	1,208	-	1,158
Equity in earnings of subsidiaries	651	137	29	(817)	-
Other income (expense), net	281	(18)	190	(438)	15
Interest and debt expense:					
Incurred	(135)	(132)	(278)	438	(107)
Capitalized	-	5	19	-	24
Income (loss) before income tax expense (benefit)	799	(60)	1,168	(817)	1,090
Income tax expense (benefit) (1)	65	(89)	380	-	356
Net income (loss)	\$ 734	\$ 29	\$ 788	\$ (817)	\$ 734

(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 June 30, 2007**  
**(unaudited, in millions)**

	<b>Valero Energy Corporation</b>	<b>PRG</b>	<b>Other Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Operating revenues	\$ -	\$ 6,080	\$ 24,936	\$ (6,814)	\$ 24,202
Costs and expenses:					
Cost of sales	-	5,116	21,008	(6,814)	19,310
Refining operating expenses	-	209	776	-	985
Retail selling expenses	-	-	200	-	200
General and administrative expenses	-	4	173	-	177
Depreciation and amortization expense	-	77	260	-	337
Total costs and expenses	-	5,406	22,417	(6,814)	21,009
Operating income	-	674	2,519	-	3,193
Equity in earnings of subsidiaries	2,095	276	540	(2,911)	-
Other income (expense), net	342	(99)	247	(483)	7
Interest and debt expense:					
Incurred	(120)	(143)	(330)	483	(110)
Capitalized	-	1	26	-	27
Income from continuing operations before income tax expense	2,317	709	3,002	(2,911)	3,117
Income tax expense (1)	68	169	818	-	1,055
Income from continuing operations	2,249	540	2,184	(2,911)	2,062
Income from discontinued operations, net of income tax expense	-	-	187	-	187
Net income	\$ 2,249	\$ 540	\$ 2,371	\$ (2,911)	\$ 2,249

- (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 Income for the Six Months Ended June 30, 2008**  
**(unaudited, in millions)**

	<b>Valero Energy Corporation</b>	<b>PRG</b>	<b>Other Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Operating revenues	\$ -	\$ 15,739	\$ 63,678	\$ (14,832)	\$ 64,585
Costs and expenses:					
Cost of sales	-	15,268	58,906	(14,832)	59,342
Refining operating expenses	-	441	1,806	-	2,247
Retail selling expenses	-	-	378	-	378
General and administrative expenses	(3)	14	241	-	252
Depreciation and amortization expense	-	138	598	-	736
Total costs and expenses	(3)	15,861	61,929	(14,832)	62,955
Operating income (loss)	3	(122)	1,749	-	1,630
Equity in earnings (losses) of subsidiaries	787	176	(92)	(871)	-
Other income (expense), net	573	(26)	382	(894)	35
Interest and debt expense:					
Incurred	(272)	(280)	(565)	894	(223)
Capitalized	-	9	34	-	43
Income (loss) before income tax expense (benefit)	1,091	(243)	1,508	(871)	1,485
Income tax expense (benefit) (1)	96	(151)	545	-	490
Net income (loss)	\$ 995	\$ (92)	\$ 963	\$ (871)	\$ 995

(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 Six Months Ended June 30, 2007**  
**(unaudited, in millions)**

	<b>Valero Energy Corporation</b>	<b>PRG</b>	<b>Other Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Consolidated</b>
Operating revenues	\$ -	\$ 10,952	\$ 41,266	\$ (9,261)	\$ 42,957
Costs and expenses:					
Cost of sales	-	9,397	34,684	(9,261)	34,820
Refining operating expenses	-	408	1,511	-	1,919
Retail selling expenses	-	-	371	-	371
General and administrative expenses	-	7	315	-	322
Depreciation and amortization expense	-	150	509	-	659
Total costs and expenses	-	9,962	37,390	(9,261)	38,091
Operating income	-	990	3,876	-	4,866
Equity in earnings of subsidiaries	3,022	342	703	(4,067)	-
Other income (expense), net	699	(131)	436	(992)	12
Interest and debt expense:					
Incurred	(214)	(305)	(672)	992	(199)
Capitalized	-	2	56	-	58
Income from continuing operations before income tax expense	3,507	898	4,399	(4,067)	4,737
Income tax expense (1)	114	259	1,214	-	1,587
Income from continuing operations	3,393	639	3,185	(4,067)	3,150
Income from discontinued operations, net of income tax expense	-	64	179	-	243
Net income	\$ 3,393	\$ 703	\$ 3,364	\$ (4,067)	\$ 3,393

(1) The income tax  
e x p e n s e

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 Six Months Ended June 30, 2008**  
**(unaudited, in millions)**

	<b>Valero Energy Corporation</b>	<b>PRG (1)</b>	<b>Other Non- Guarantor Subsidiaries (1)</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net cash provided by operating activities	\$ 274	\$ 65	\$ 1,463	\$ -	\$ 1,802
Cash flows from investing activities:					
Capital expenditures	-	(247)	(931)	-	(1,178)
Deferred turnaround and catalyst costs	-	(50)	(153)	-	(203)
Return of investment in Cameron Highway Oil Pipeline Company, net	-	-	12	-	12
Advance proceeds related to sale of assets	-	-	17	-	17
Contingent payments in connection with acquisitions	-	-	(25)	-	(25)
Investments in subsidiaries	(215)	-	-	215	-
Net intercompany loan repayments	210	-	-	(210)	-
Minor acquisitions and other investing activities, net	-	-	(43)	-	(43)
Net cash used in investing activities	(5)	(297)	(1,123)	5	(1,420)
Cash flows from financing activities:					
Long-term note repayments	(6)	(368)	-	-	(374)
Bank credit agreements:					
Borrowings	296	-	-	-	296
Repayments	(296)	-	-	-	(296)
Purchase of common stock for treasury	(700)	-	-	-	(700)
Issuance of common stock in connection with employee benefit plans	11	-	-	-	11
Benefit from tax deduction in excess of recognized stock-based compensation cost	13	-	-	-	13

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Common stock dividends	(143)	-	-	-	(143)
Net intercompany borrowings (repayments)	-	600	(810)	210	-
Capital contributions from parent	-	-	215	(215)	-
Other financing activities	-	-	(2)	-	(2)
Net cash provided by (used in) financing activities	(825)	232	(597)	(5)	(1,195)
Effect of foreign exchange rate changes on cash	-	-	(7)	-	(7)
Net decrease in cash and temporary cash investments	(556)	-	(264)	-	(820)
Cash and temporary cash investments at beginning of period	1,414	-	1,050	-	2,464
Cash and temporary cash investments at end of period	\$ 858	\$ -	\$ 786	\$ -	\$ 1,644

(1) The information presented herein excludes a \$918 million noncash capital contribution of property and other assets, net of certain liabilities, from PRG to Valero Refining Company-Tennessee, L.L.C. (included in Other Non-Guarantor Subsidiaries ) on April 1, 2008.

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**VALERO ENERGY CORPORATION AND SUBSIDIARIES**  
**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)**  
**Condensed Consolidating Statement of Cash Flows for the Six Months Ended June 30, 2007**  
**(unaudited, in millions)**

	<b>Valero Energy Corporation</b>	<b>PRG (1)</b>	<b>Other Non- Guarantor Subsidiaries (1)</b>	<b>Eliminations</b>	<b>Consolidated</b>
Net cash provided by operating activities	\$ 985	\$ 591	\$ 2,775	\$ -	\$ 4,351
Cash flows from investing activities:					
Capital expenditures	-	(168)	(874)	-	(1,042)
Deferred turnaround and catalyst costs	-	(24)	(206)	-	(230)
Investment in Cameron Highway Oil Pipeline Company, net	-	-	(215)	-	(215)
Advance proceeds related to sale of assets	-	-	96	-	96
Contingent payments in connection with acquisitions	-	(25)	(50)	-	(75)
Investments in subsidiaries	(3,658)	(58)	-	3,716	-
Return of investment	2,222	-	3	(2,225)	-
Net intercompany loan repayments	3,100	-	-	(3,100)	-
Other investing activities, net	-	5	10	-	15
Net cash provided by (used in) investing activities	1,664	(270)	(1,236)	(1,609)	(1,451)
Cash flows from financing activities:					
Long-term notes:					
Borrowings	2,245	-	-	-	2,245
Repayments	(230)	(183)	-	-	(413)
Bank credit agreements:					
Borrowings	3,000	-	-	-	3,000
Repayments	(3,000)	-	-	-	(3,000)
Purchase of common stock for treasury	(4,181)	-	-	-	(4,181)
Issuance of common stock in connection with employee benefit plans	111	-	-	-	111
Benefit from tax deduction in excess of recognized stock-based compensation cost	215	-	-	-	215
Common stock dividends	(139)	-	-	-	(139)
Dividends to parent	-	(3)	(2,222)	2,225	-
Capital contributions from parent	-	-	3,716	(3,716)	-
Net intercompany loan repayments	-	(135)	(2,965)	3,100	-
Other financing activities	(19)	-	(2)	-	(21)

Net cash used in financing activities	(1,998)	(321)	(1,473)	1,609	(2,183)
Effect of foreign exchange rate changes on cash	-	-	29	-	29
Net increase in cash and temporary cash investments	651	-	95	-	746
Cash and temporary cash investments at beginning of period	712	-	878	-	1,590
Cash and temporary cash investments at end of period	\$ 1,363	\$ -	\$ 973	\$ -	\$ 2,336

(1) The information presented herein excludes a \$686 million noncash capital contribution of property and other assets, net of certain liabilities, from PRG to Lima Refining Company (included in Other Non-Guarantor Subsidiaries ) on April 1, 2007, in anticipation of the sale of the Lima Refinery as discussed in Note 3.

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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.



**Table of Contents*****OVERVIEW***

In this overview, we describe some of the primary factors that we believe affected our operations in the first six months 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 six months of 2008. Gasoline margins declined significantly in the first six months of 2008 compared to the same period in the prior year. 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 refined products, such as asphalt, fuel oils, petroleum coke, and petrochemical feedstocks during the first six months of 2008. However, diesel margins in the first six months of 2008 were favorable compared to the first six months of 2007 primarily due to continued strong global demand.

Because more than 65% of our total crude oil throughput consists of 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. Sour crude oil differentials for the first six months of 2008 remained wide and improved compared to the differentials in the first six months of 2007, thereby significantly benefiting our results of operations in the 2008 period.

Regarding operations, 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 during the second quarter of 2008, we completed the repairs and resumed full operations of the refinery. During the first six months of 2008, this incident reduced our operating income by approximately \$220 million.

The unfavorable effect of weaker margins for gasoline and secondary refined products more than offset favorable diesel margins and sour crude oil differentials in the second quarter and first six months of 2008. We reported income from continuing operations of \$734 million, or \$1.37 per share, for the second quarter of 2008, compared to \$2.1 billion, or \$3.57 per share, for the second quarter of 2007. Income from continuing operations was \$995 million, or \$1.85 per share, for the first six months of 2008 compared to \$3.2 billion, or \$5.28 per share, for the first six months of 2007. The results for the first six months of 2008 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 six months of 2008, we purchased \$700 million of our common stock under our board-authorized programs and repaid \$367 million of callable debt that was due in 2013. In addition, during the second quarter of 2008, we increased our quarterly common stock dividend by 25% to \$0.15 per share.

Effective July 1, 2008, we sold our refinery in Krotz Springs, Louisiana to Alon Refining Krotz Springs, Inc. (Alon), a subsidiary of Alon USA Energy, Inc. Initial proceeds from the sale were \$333 million, plus \$143 million for a preliminary working capital settlement. In addition, we received contingent consideration in the form of a three-year earn-out agreement based on certain product margins.

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

	<b>Three Months Ended June 30,</b>		
	<b>2008</b>	<b>2007 (a)</b>	<b>Change</b>
Operating revenues	\$ 36,640	\$ 24,202	\$ 12,438
Costs and expenses:			
Cost of sales	33,673	19,310	14,363
Refining operating expenses	1,133	985	148
Retail selling expenses	190	200	(10)
General and administrative expenses	117	177	(60)
Depreciation and amortization expense:			
Refining	336	302	34
Retail	24	22	2
Corporate	9	13	(4)
Total costs and expenses	35,482	21,009	14,473
Operating income	1,158	3,193	(2,035)
Other income, net	15	7	8
Interest and debt expense:			
Incurred	(107)	(110)	3
Capitalized	24	27	(3)
Income from continuing operations before income tax expense	1,090	3,117	(2,027)
Income tax expense	356	1,055	(699)
Income from continuing operations	734	2,062	(1,328)
Income from discontinued operations, net of income tax expense	-	187	(187)
Net income	\$ 734	\$ 2,249	\$ (1,515)
Earnings per common share assuming dilution:			
Continuing operations	\$ 1.37	\$ 3.57	\$ (2.20)
Discontinued operations	-	0.32	(0.32)
Total	\$ 1.37	\$ 3.89	\$ (2.52)

See the footnote  
references on page  
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**Operating Highlights**  
*(millions of dollars, except per barrel and per gallon amounts)*

	<b>Three Months Ended June 30,</b>		
	<b>2008</b>	<b>2007</b>	<b>Change</b>
<b>Refining (a):</b>			
Operating income	\$ 1,235	\$ 3,327	\$ (2,092)
Throughput margin per barrel (b)	\$ 10.82	\$ 18.14	\$ (7.32)
Operating costs per barrel:			
Refining operating expenses	\$ 4.53	\$ 3.87	\$ 0.66
Depreciation and amortization	1.35	1.19	0.16
Total operating costs per barrel	\$ 5.88	\$ 5.06	\$ 0.82
Throughput volumes (thousand barrels per day):			
Feedstocks:			
Heavy sour crude	593	618	(25)
Medium/light sour crude	715	650	65
Acidic sweet crude	80	86	(6)
Sweet crude	658	717	(59)
Residuals	253	273	(20)
Other feedstocks	128	150	(22)
Total feedstocks	2,427	2,494	(67)
Blendstocks and other	319	300	19
Total throughput volumes	2,746	2,794	(48)
Yields (thousand barrels per day):			
Gasolines and blendstocks	1,232	1,277	(45)
Distillates	982	913	69
Petrochemicals	77	81	(4)
Other products (c)	446	517	(71)
Total yields	2,737	2,788	(51)
<b>Retail U.S.:</b>			
Operating income	\$ 25	\$ 37	\$ (12)
Company-operated fuel sites (average)	949	958	(9)
Fuel volumes (gallons per day per site)	5,104	5,006	98
Fuel margin per gallon	\$ 0.129	\$ 0.202	\$ (0.073)
Merchandise sales	\$ 282	\$ 269	\$ 13
Merchandise margin (percentage of sales)	29.8%	29.8%	-%
Margin on miscellaneous sales	\$ 22	\$ 24	\$ (2)
Retail selling expenses	\$ 121	\$ 139	\$ (18)
Depreciation and amortization expense	\$ 16	\$ 16	\$ -
<b>Retail Canada:</b>			
Operating income	\$ 24	\$ 19	\$ 5
Fuel volumes (thousand gallons per day)	3,103	3,144	(41)
Fuel margin per gallon	\$ 0.270	\$ 0.222	\$ 0.048

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Merchandise sales	\$ 54	\$ 47	\$ 7
Merchandise margin (percentage of sales)	28.6%	28.3%	0.3%
Margin on miscellaneous sales	\$ 10	\$ 9	\$ 1
Retail selling expenses	\$ 69	\$ 61	\$ 8
Depreciation and amortization expense	\$ 8	\$ 6	\$ 2

See the footnote  
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***Refining Operating Highlights by Region (d)***  
***(millions of dollars, except per barrel amounts)***

	<b>Three Months Ended June 30,</b>		
	<b>2008</b>	<b>2007</b>	<b>Change</b>
<b>Gulf Coast:</b>			
Operating income	\$ 1,043	\$ 1,935	\$ (892)
Throughput volumes (thousand barrels per day)	1,495	1,543	(48)
Throughput margin per barrel (b)	\$ 13.25	\$ 18.52	\$ (5.27)
Operating costs per barrel:			
Refining operating expenses	\$ 4.34	\$ 3.65	\$ 0.69
Depreciation and amortization	1.24	1.09	0.15
Total operating costs per barrel	\$ 5.58	\$ 4.74	\$ 0.84
<b>Mid-Continent (a):</b>			
Operating income	\$ 103	\$ 483	\$ (380)
Throughput volumes (thousand barrels per day)	439	373	66
Throughput margin per barrel (b)	\$ 7.85	\$ 19.96	\$ (12.11)
Operating costs per barrel:			
Refining operating expenses	\$ 3.99	\$ 4.42	\$ (0.43)
Depreciation and amortization	1.27	1.34	(0.07)
Total operating costs per barrel	\$ 5.26	\$ 5.76	\$ (0.50)
<b>Northeast:</b>			
Operating income (loss)	\$ (35)	\$ 523	\$ (558)
Throughput volumes (thousand barrels per day)	527	577	(50)
Throughput margin per barrel (b)	\$ 5.81	\$ 14.83	\$ (9.02)
Operating costs per barrel:			
Refining operating expenses	\$ 5.06	\$ 3.62	\$ 1.44
Depreciation and amortization	1.49	1.25	0.24
Total operating costs per barrel	\$ 6.55	\$ 4.87	\$ 1.68
<b>West Coast:</b>			
Operating income	\$ 124	\$ 386	\$ (262)
Throughput volumes (thousand barrels per day)	285	301	(16)
Throughput margin per barrel (b)	\$ 11.92	\$ 20.35	\$ (8.43)
Operating costs per barrel:			
Refining operating expenses	\$ 5.41	\$ 4.81	\$ 0.60
Depreciation and amortization	1.73	1.42	0.31
Total operating costs per barrel	\$ 7.14	\$ 6.23	\$ 0.91

See the footnote  
 references on page  
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**Table of Contents*****Average Market Reference Prices and Differentials (e)***  
***(dollars per barrel)***

	<b>Three Months Ended June 30,</b>		
	<b>2008</b>	<b>2007</b>	<b>Change</b>
<b>Feedstocks:</b>			
West Texas Intermediate (WTI) crude oil	\$ 123.98	\$ 64.89	\$ 59.09
WTI less sour crude oil at U.S. Gulf Coast (f)	5.70	3.08	2.62
WTI less Mars crude oil	6.96	2.70	4.26
WTI less Alaska North Slope (ANS) crude oil	0.19	(0.86)	1.05
WTI less Maya crude oil	20.99	9.60	11.39
<b>Products:</b>			
<b>U.S. Gulf Coast:</b>			
Conventional 87 gasoline less WTI	6.60	28.95	(22.35)
No. 2 fuel oil less WTI	23.03	14.95	8.08
Ultra-low-sulfur diesel less WTI	28.85	22.26	6.59
Propylene less WTI	(6.77)	16.67	(23.44)
<b>U.S. Mid-Continent:</b>			
Conventional 87 gasoline less WTI	5.89	34.09	(28.20)
Low-sulfur diesel less WTI	28.84	25.61	3.23
<b>U.S. Northeast:</b>			
Conventional 87 gasoline less WTI	4.34	26.15	(21.81)
No. 2 fuel oil less WTI	24.94	15.41	9.53
Lube oils less WTI	33.65	53.25	(19.60)
<b>U.S. West Coast:</b>			
CARBOB 87 gasoline less ANS	16.27	37.36	(21.09)
CARB diesel less ANS	31.02	26.16	4.86

The following notes relate to references on pages 34 through 37.

- (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 June 30, 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 June 30, 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.

**Table of Contents****General**

Operating revenues increased 51% for the second quarter of 2008 compared to the second quarter of 2007 primarily as a result of higher refined product prices between the two periods. Operating income of \$1.2 billion and income from continuing operations of \$734 million for the three months ended June 30, 2008 both decreased 64% from the corresponding amounts in the second quarter of 2007 primarily due to a \$2.1 billion decrease in refining segment operating income discussed below. The refining segment operating income and income from continuing operations for the three months ended June 30, 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 \$3.3 billion for the second quarter of 2007 to \$1.2 billion for the second quarter of 2008, resulting from a 40% decrease in throughput margin per barrel, a 14% increase in refining operating expenses (including depreciation and amortization expense), and a 2% decline in throughput volumes.

Total refining throughput margins for the second quarter of 2008 compared to the second quarter of 2007 were impacted by the following factors:

Gasoline margins decreased significantly in all of our refining regions in the second quarter of 2008 compared to the margins in the second quarter of 2007. The decline in gasoline margins for the second 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 second quarter of 2007 to the second 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 second quarter of 2008 increased in all of our refining regions from the margins in the second quarter of 2007. The increase in distillate margins was primarily due to continued strong global demand.

Medium and heavy sour crude oil feedstock differentials to WTI crude oil during the second quarter of 2008 remained wide and were approximately double the differentials in the second 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 48,000 barrels per day during the second quarter of 2008 compared to the second quarter of 2007 due to the fire at our Aruba Refinery discussed in Note 13 of Condensed Notes to Consolidated Financial Statements, downtime for maintenance at our Port Arthur and Delaware City Refineries, and economic decisions to reduce throughputs in certain of our refineries as a result of unfavorable market fundamentals, partially offset by the 2007 shutdown of our McKee Refinery discussed in Note 13 of Condensed Notes to Consolidated Financial Statements.

Refining operating expenses, excluding depreciation and amortization expense, were 15% higher for the quarter ended June 30, 2008 compared to the quarter ended June 30, 2007 primarily due to an increase in energy costs for electricity and natural gas. Refining depreciation and amortization expense increased

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11% from the second quarter of 2007 to the second quarter of 2008 primarily due to the implementation of new capital projects and increased turnaround and catalyst amortization.

**Retail**

Retail operating income of \$49 million for the quarter ended June 30, 2008 decreased by approximately 13% compared to the \$56 million reported for the quarter ended June 30, 2007 primarily due to a \$0.07 per gallon decrease in average fuel margins in our U.S. retail operations, partially offset by decreased selling expenses mainly attributable to \$16 million of costs associated with a reorganization of our U.S. retail operations in the second quarter of 2007.

**Corporate Expenses and Other**

General and administrative expenses, including depreciation and amortization expense, decreased \$64 million from the second quarter of 2007 to the second quarter of 2008 primarily due to a nonrecurring \$13 million termination fee paid in the second quarter of 2007 for the cancellation of our services agreement with NuStar Energy L.P., lower variable compensation expenses, and decreases in legal costs and charitable contributions.

Income tax expense decreased \$699 million from the second quarter of 2007 to the second quarter of 2008 mainly as a result of lower operating income.

Income from discontinued operations for the three months ended June 30, 2007 represents net income from the operations of the Lima Refinery prior to its sale effective July 1, 2007.

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**Six Months Ended June 30, 2008 Compared to Six Months Ended June 30, 2007**  
**Financial Highlights**  
*(millions of dollars, except per share amounts)*

	<b>Six Months Ended June 30,</b>		
	<b>2008</b>	<b>2007 (a)</b>	<b>Change</b>
Operating revenues	\$ 64,585	\$ 42,957	\$ 21,628
Costs and expenses:			
Cost of sales	59,342	34,820	24,522
Refining operating expenses	2,247	1,919	328
Retail selling expenses	378	371	7
General and administrative expenses	252	322	(70)
Depreciation and amortization expense:			
Refining	667	595	72
Retail	49	40	9
Corporate	20	24	(4)
Total costs and expenses	62,955	38,091	24,864
Operating income	1,630	4,866	(3,236)
Other income, net	35	12	23
Interest and debt expense:			
Incurred	(223)	(199)	(24)
Capitalized	43	58	(15)
Income from continuing operations before income tax expense	1,485	4,737	(3,252)
Income tax expense	490	1,587	(1,097)
Income from continuing operations	995	3,150	(2,155)
Income from discontinued operations, net of income tax expense	-	243	(243)
Net income	\$ 995	\$ 3,393	\$ (2,398)
Earnings per common share assuming dilution:			
Continuing operations	\$ 1.85	\$ 5.28	\$ (3.43)
Discontinued operations	-	0.40	(0.40)
Total	\$ 1.85	\$ 5.68	\$ (3.83)

See the footnote  
references on page  
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**Operating Highlights**  
*(millions of dollars, except per barrel and per gallon amounts)*

	<b>Six Months Ended June 30,</b>		
	<b>2008</b>	<b>2007</b>	<b>Change</b>
<b>Refining (a):</b>			
Operating income	\$ 1,803	\$ 5,103	\$ (3,300)
Throughput margin per barrel (b)	\$ 9.68	\$ 15.19	\$ (5.51)
Operating costs per barrel:			
Refining operating expenses	\$ 4.61	\$ 3.83	\$ 0.78
Depreciation and amortization	1.37	1.18	0.19
Total operating costs per barrel	\$ 5.98	\$ 5.01	\$ 0.97
Throughput volumes (thousand barrels per day):			
Feedstocks:			
Heavy sour crude	587	654	(67)
Medium/light sour crude	685	632	53
Acidic sweet crude	77	85	(8)
Sweet crude	643	711	(68)
Residuals	223	259	(36)
Other feedstocks	144	151	(7)
Total feedstocks	2,359	2,492	(133)
Blendstocks and other	318	278	40
Total throughput volumes	2,677	2,770	(93)
Yields (thousand barrels per day):			
Gasolines and blendstocks	1,228	1,263	(35)
Distillates	927	912	15
Petrochemicals	77	82	(5)
Other products (c)	442	513	(71)
Total yields	2,674	2,770	(96)
<b>Retail U.S.:</b>			
Operating income	\$ 39	\$ 61	\$ (22)
Company-operated fuel sites (average)	949	961	(12)
Fuel volumes (gallons per day per site)	5,023	4,994	29
Fuel margin per gallon	\$ 0.121	\$ 0.163	\$ (0.042)
Merchandise sales	\$ 527	\$ 502	\$ 25
Merchandise margin (percentage of sales)	30.1%	29.9%	0.2%
Margin on miscellaneous sales	\$ 50	\$ 49	\$ 1
Retail selling expenses	\$ 241	\$ 252	\$ (11)
Depreciation and amortization expense	\$ 33	\$ 27	\$ 6

**Retail Canada:**

Operating income	\$ 60	\$ 48	\$ 12
Fuel volumes (thousand gallons per day)	3,191	3,257	(66)
Fuel margin per gallon	\$ 0.286	\$ 0.234	\$ 0.052
Merchandise sales	\$ 100	\$ 84	\$ 16
Merchandise margin (percentage of sales)	28.5%	28.8%	(0.3)%
Margin on miscellaneous sales	\$ 19	\$ 18	\$ 1
Retail selling expenses	\$ 137	\$ 119	\$ 18
Depreciation and amortization expense	\$ 16	\$ 13	\$ 3

See the footnote  
references on page  
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***Refining Operating Highlights by Region (d)***  
***(millions of dollars, except per barrel amounts)***

	<b>Six Months Ended June 30,</b>		
	<b>2008</b>	<b>2007</b>	<b>Change</b>
<b>Gulf Coast:</b>			
Operating income	\$ 1,480	\$ 3,018	\$ (1,538)
Throughput volumes (thousand barrels per day)	1,437	1,534	(97)
Throughput margin per barrel (b)	\$ 11.46	\$ 15.47	\$ (4.01)
Operating costs per barrel:			
Refining operating expenses	\$ 4.52	\$ 3.55	\$ 0.97
Depreciation and amortization	1.28	1.05	0.23
Total operating costs per barrel	\$ 5.80	\$ 4.60	\$ 1.20
<b>Mid-Continent (a):</b>			
Operating income	\$ 218	\$ 574	\$ (356)
Throughput volumes (thousand barrels per day)	426	363	63
Throughput margin per barrel (b)	\$ 8.28	\$ 14.81	\$ (6.53)
Operating costs per barrel:			
Refining operating expenses	\$ 4.16	\$ 4.57	\$ (0.41)
Depreciation and amortization	1.30	1.50	(0.20)
Total operating costs per barrel	\$ 5.46	\$ 6.07	\$ (0.61)
<b>Northeast:</b>			
Operating income (loss)	\$ (30)	\$ 812	\$ (842)
Throughput volumes (thousand barrels per day)	541	575	(34)
Throughput margin per barrel (b)	\$ 5.91	\$ 12.73	\$ (6.82)
Operating costs per barrel:			
Refining operating expenses	\$ 4.77	\$ 3.69	\$ 1.08
Depreciation and amortization	1.45	1.24	0.21
Total operating costs per barrel	\$ 6.22	\$ 4.93	\$ 1.29
<b>West Coast:</b>			
Operating income	\$ 135	\$ 699	\$ (564)
Throughput volumes (thousand barrels per day)	273	298	(25)
Throughput margin per barrel (b)	\$ 9.99	\$ 18.97	\$ (8.98)
Operating costs per barrel:			
Refining operating expenses	\$ 5.48	\$ 4.60	\$ 0.88
Depreciation and amortization	1.80	1.41	0.39
Total operating costs per barrel	\$ 7.28	\$ 6.01	\$ 1.27



See the footnote  
references on page  
43.

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

	<b>Six Months Ended June 30,</b>		
	<b>2008</b>	<b>2007</b>	<b>Change</b>
<b>Feedstocks:</b>			
WTI crude oil	\$ 110.96	\$ 61.45	\$ 49.51
WTI less sour crude oil at U.S. Gulf Coast (f)	5.77	4.50	1.27
WTI less Mars crude oil	6.97	3.81	3.16
WTI less ANS crude oil	0.75	0.72	0.03
WTI less Maya crude oil	18.90	11.11	7.79
<b>Products:</b>			
<b>U.S. Gulf Coast:</b>			
Conventional 87 gasoline less WTI	5.42	19.58	(14.16)
No. 2 fuel oil less WTI	19.11	12.38	6.73
Ultra-low-sulfur diesel less WTI	24.61	19.81	4.80
Propylene less WTI	(3.77)	16.44	(20.21)
<b>U.S. Mid-Continent:</b>			
Conventional 87 gasoline less WTI	5.43	23.11	(17.68)
Low-sulfur diesel less WTI	24.88	22.97	1.91
<b>U.S. Northeast:</b>			
Conventional 87 gasoline less WTI	3.70	19.08	(15.38)
No. 2 fuel oil less WTI	21.35	13.38	7.97
Lube oils less WTI	32.97	58.53	(25.56)
<b>U.S. West Coast:</b>			
CARBOB 87 gasoline less ANS	13.32	33.67	(20.35)
CARB diesel less ANS	26.14	26.35	(0.21)

The following notes relate to references on pages 40 through 43.

- (a) Effective July 1, 2007, we sold our Lima Refinery to Husky. Therefore, the results of operations of the Lima Refinery for the six months ended June 30, 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 six months ended June 30, 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 50% for the first six months of 2008 compared to the first six months of 2007 primarily as a result of higher refined product prices between the two periods. Operating income of \$1.6 billion and income from continuing operations of \$1.0 billion for the six months ended June 30, 2008 decreased 67% and 68%, respectively, from the corresponding amounts in the first six months of 2007 primarily due to a \$3.3 billion decrease in refining segment operating income discussed below. The refining segment operating income and income from continuing operations for the six months ended June 30, 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 \$5.1 billion for the first six months of 2007 to \$1.8 billion for the first six months of 2008, resulting from a 36% decrease in throughput margin per barrel, a 16% increase in refining operating expenses (including depreciation and amortization expense), and a 3% decline in throughput volumes.

Total refining throughput margins for the first six months of 2008 compared to the first six months of 2007 were impacted by the following factors:

Gasoline margins decreased significantly in all of our refining regions in the first six months of 2008 compared to the margins in the first six months of 2007. The decline in gasoline margins for the first six months 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 six months of 2007 to the first six months 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.

Average distillate margins in the first six months of 2008 increased significantly from the margins in the first six months of 2007. The increase in distillate margins was primarily due to continued strong global demand.

Medium and heavy sour crude oil feedstock differentials to WTI crude oil during the first six months of 2008 remained wide and were wider than the differentials in the first six months 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 93,000 barrels per day during the first six months of 2008 compared to the first six months of 2007 due to the fire at our Aruba Refinery discussed in Note 13 of Condensed Notes to Consolidated Financial Statements, downtime for maintenance at our Port Arthur and Delaware City Refineries, and economic decisions to reduce throughputs in certain of our refineries as a result of unfavorable market fundamentals, partially offset by the 2007 shutdown of our McKee Refinery discussed in Note 13 of Condensed Notes to Consolidated Financial Statements.

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

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Refining operating expenses, excluding depreciation and amortization expense, were 17% higher for the six months ended June 30, 2008 compared to the six months ended June 30, 2007 primarily due to increases in energy costs, maintenance expense, and outside services. Refining depreciation and amortization expense increased 12% from the first six months of 2007 to the first six months of 2008 primarily due to the implementation of new capital projects and increased turnaround and catalyst amortization.

**Retail**

Retail operating income of \$99 million for the six months ended June 30, 2008 decreased by approximately 9% compared to the \$109 million reported for the six months ended June 30, 2007 as increases in selling expenses and depreciation and amortization expense, combined with a \$0.04 per gallon decline in average fuel margins in our U.S. retail operations, more than offset higher margins from fuel sales in Canada and an increase in in-store sales.

**Corporate Expenses and Other**

General and administrative expenses, including depreciation and amortization expense, decreased \$74 million from the first six months of 2007 to the first six months of 2008 primarily due to the nonrecurrence of 2007 expenses related to executive retirement costs and a \$13 million termination fee paid for the cancellation of our services agreement with NuStar Energy L.P., lower variable compensation expenses, and decreases in legal costs and charitable contributions.

Other income, net for the first six months of 2008 included 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 six months of 2007 to the first six months 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 from a reduced balance of capital projects under construction and lower interest rates, partially offset by the effect of debt repayments during 2007 and 2008.

Income tax expense decreased \$1.1 billion from the first six months of 2007 to the first six months of 2008 mainly as a result of lower operating income.

Income from discontinued operations for the six months ended June 30, 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 continues to be mixed. With respect to the gasoline market, we expect the high price of crude oil and other feedstocks, high retail prices, and the economic slowdown to continue to unfavorably impact gasoline demand. We expect the combination of weak demand and growing competition from ethanol to continue pressuring gasoline margins. As a result, we expect continuing industry-wide reductions in gasoline production. Our outlook for distillate margins is more favorable as diesel demand globally continues to be strong.

In regard to feedstocks, sour crude oil differentials have declined from second quarter levels. However, we expect sour crude oil differentials to be favorable during the second half of 2008. Although residual

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fuel oil differentials have narrowed in July, we expect those differentials to increase later in the third quarter, which should contribute to continuing wide sour crude oil differentials.

With the completion of maintenance performed at the Aruba, Port Arthur, and Delaware City Refineries in the second quarter of 2008, we expect operations at those refineries to return to normal levels in the third quarter. Our turnaround schedule for the third quarter is relatively light, which should benefit our results of operations during the quarter.

***LIQUIDITY AND CAPITAL RESOURCES***

***Cash Flows for the Six Months Ended June 30, 2008 and 2007***

Net cash provided by operating activities for the six months ended June 30, 2008 was \$1.8 billion compared to \$4.4 billion for the six months ended June 30, 2007. The decrease in cash generated from operating activities was primarily due to the decrease in net income discussed above under Results of Operations, partially offset by a \$129 million increase from a favorable change in working capital between the periods. Changes in cash provided by or used for working capital during the first six months of 2008 and 2007 are shown in Note 8 of Condensed Notes to Consolidated Financial Statements. Working capital changes in the first six months of 2008 were impacted in large part by the following factors: (i) a significant increase in crude oil prices, (ii) the termination in the first quarter of 2008 of certain agreements related to the sale of the Lima Refinery to Husky, (iii) a reduction in throughput and sales volumes mainly due to downtime at certain of our refineries, and (iv) delayed receivable collections at year-end 2007. The net cash generated from operating activities during the first six months of 2008, combined with \$820 million of available cash on hand, were used mainly to:

fund \$1.4 billion 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 12.6 million shares of our common stock at a cost of \$700 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 \$143 million.

The net cash generated from operating activities during the first six months of 2007, combined with \$2.245 billion of proceeds from the issuance of long-term notes, a \$215 million benefit from tax deductions in excess of recognized stock-based compensation cost, and \$111 million of proceeds from the issuance of common stock related to our employee benefit plans, were used mainly to:

fund \$1.3 billion of capital expenditures and deferred turnaround and catalyst costs;

purchase 61.9 million shares of our common stock at a cost of \$4.2 billion;

make an early debt repurchase of \$183 million and a scheduled debt repayment of \$230 million;

fund capital contributions of \$215 million to Cameron Highway Oil Pipeline Company to enable the joint venture to redeem all of its outstanding debt;

fund contingent earn-out payments in connection with the acquisition of the St. Charles Refinery and the Delaware City Refinery of \$50 million and \$25 million, respectively;

pay common stock dividends of \$139 million; and

increase available cash on hand by \$746 million.

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

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six months ended June 30, 2007. Cash provided by operating activities related to our discontinued operations was \$260 million for the six months ended June 30, 2007. Cash used in investing activities related to the Lima Refinery was \$14 million for the six months ended June 30, 2007.

***Capital Investments***

During the six months ended June 30, 2008, we expended \$1.2 billion for capital expenditures and \$203 million for deferred turnaround and catalyst costs. Capital expenditures for the six months ended June 30, 2008 included \$236 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 \$3.8 billion for capital investments, including approximately \$3.4 billion for capital expenditures (approximately \$600 million of which is for environmental projects) and approximately \$400 million for deferred turnaround and catalyst costs. The capital expenditure estimate excludes expenditures incurred in 2008 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.

***Krotz Springs Refinery Disposition***

Effective July 1, 2008, we consummated the sale of our Krotz Springs Refinery to Alon. Initial proceeds from the sale were \$333 million, plus \$143 million representing a preliminary working capital settlement related to the sale of inventory by our marketing and supply subsidiary. The working capital settlement is expected to be finalized within 90 days after the effective date of the sale. In addition to the cash consideration received, we also received contingent consideration in the form of a three-year earn-out agreement based on certain product margins, which had a fair value of approximately \$170 million as of July 1, 2008. We have hedged the risk of a decline in the referenced product margins subsequent to the acquisition date by entering into certain commodity derivative contracts. In addition, we entered into various agreements with Alon as further described in Note 3 of Condensed Notes to Consolidated Financial Statements.

***Contractual Obligations***

As of June 30, 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 six months ended June 30, 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.



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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 June 30, 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 June 30, 2008, our committed lines of credit included:

	<b>Borrowing Capacity</b>	<b>Expiration</b>
Letter of credit facility	\$300 million	June 2009
Revolving credit facility	\$2.5 billion	November 2012
Canadian revolving credit facility	Cdn. \$115 million	December 2012

In June 2008, we entered into a one-year committed revolving letter of credit facility under which we may obtain letters of credit of up to \$300 million to support certain of our crude oil purchases. We are being charged letter of credit issuance fees in connection with the letter of credit facility.

As of June 30, 2008, we had \$663 million of letters of credit outstanding under our uncommitted short-term bank credit facilities and \$898 million of letters of credit outstanding under our committed revolving credit facilities, excluding our Canadian facility. Under our Canadian committed revolving credit facility, we had Cdn. \$16 million of letters of credit outstanding as of June 30, 2008. These letters of credit expire during 2008 and 2009.

**Stock Purchase Programs**

During the first six months of 2008, we purchased 12.6 million shares of our common stock at a cost of \$700 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 June 30, 2008, we had made no purchases of our common stock under the new \$3 billion program. As of June 30, 2008, we have approvals under these stock purchase programs to purchase approximately \$3.7 billion of our common stock.

**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.

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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, which totaled approximately \$70 million as of June 30, 2008, are reflected as restricted cash in our consolidated balance sheet.

***Other***

In July 2008, we entered into an agreement to participate as a prospective shipper on the 500,000 barrel-per-day expansion of the Keystone crude oil pipeline system, which is expected to be completed by 2012. Once completed, the pipeline will enable crude oil to be transported from Western Canada to the U.S. Gulf Coast at Port Arthur, Texas. In addition to our commitment to ship crude oil through the pipeline, we have an option to acquire an equity interest in the Keystone partnerships. We have also secured commitments from several Canadian oil producers to sell to us heavy sour crude oil for shipment through the pipeline.

In April 2008, we made a \$20 million contribution to our qualified pension plans, and in July 2008, we made an additional \$80 million contribution to those plans. We do not expect to make any additional contributions 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 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. As of June 30, 2008, we had completed the repairs and resumed full operations of the refinery. During the first six months of 2008, this incident reduced our operating income by approximately \$220 million.

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 are continuing to pursue potential transactions for these assets, which may include the sale of these assets.

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

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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 December 31, 2007, we had an accounts receivable sales facility with a group of third-party entities and financial institutions to sell on a revolving basis up to \$1 billion of eligible trade receivables. The facility had a maturity date of August 2008. In June 2008, we amended our agreement to extend the maturity date to June 2009. As of June 30, 2008 and December 31, 2007, the amount of eligible receivables sold to the third parties 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 June 30, 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 \$4.6 billion and \$3.8 billion as of June 30, 2008 and December 31, 2007, respectively, and a fair value of \$15.0 billion and \$10.0 billion as of June 30, 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.

			<b>June 30, 2008</b>			
	<b>Contract Volumes</b>	<b>Wtd Avg Pay Price</b>	<b>Wtd Avg Receive Price</b>	<b>Contract Value</b>	<b>Market Value</b>	<b>Pre-tax Fair Value</b>
<b><u>Fair Value Hedges:</u></b>						
<b>Futures long:</b>						
2008 (crude oil and refined products)	11,332	\$ 135.66	N/A	\$ 1,537	\$ 1,587	\$ 50
<b>Futures short:</b>						
2008 (crude oil and refined products)	18,930	N/A	\$ 133.16	2,521	2,654	(133)
<b><u>Cash Flow Hedges:</u></b>						
<b>Swaps long:</b>						
2008 (crude oil and refined products)	10,650	102.07	141.09	N/A	416	416
2009 (crude oil and refined products)	12,060	118.75	140.64	N/A	264	264
<b>Swaps short:</b>						
2008 (crude oil and refined products)	10,650	168.01	121.51	N/A	(495)	(495)
2009 (crude oil and refined products)	12,060	167.84	144.01	N/A	(287)	(287)
<b>Futures long:</b>						
2008 (crude oil and refined products)	1,408	131.76	N/A	186	198	12
<b>Futures short:</b>						
2008 (crude oil and refined products)	980	N/A	124.08	122	138	(16)
<b><u>Economic Hedges:</u></b>						
<b>Swaps long:</b>						
2008 (crude oil and refined products)	14,028	71.97	77.88	N/A	83	83
2009 (crude oil and refined products)	9,000	127.18	140.64	N/A	121	121
2010 (crude oil and refined products)	9,600	126.67	138.29	N/A	112	112
2011 (crude oil and refined products)	3,900	124.78	136.92	N/A	47	47
<b>Swaps short:</b>						
2008 (crude oil and refined products)	10,798	110.59	103.95	N/A	(72)	(72)
2009 (crude oil and refined products)	9,000	157.40	144.35	N/A	(117)	(117)
	9,600	154.10	140.29	N/A	(133)	(133)

2010 (crude oil and refined products)						
2011 (crude oil and refined products)	3,900	150.41	136.66	N/A	(54)	(54)
Futures long:						
2008 (crude oil and refined products)	38,922	138.92	N/A	5,407	5,732	325
2009 (crude oil and refined products)	45	160.79	N/A	7	7	-
2008 (natural gas)	750	12.67	N/A	10	10	-
Futures short:						
2008 (crude oil and refined products)	36,213	N/A	134.31	4,864	5,316	(452)
2009 (crude oil and refined products)	18	N/A	163.83	3	3	-
<b><u>Trading Activities:</u></b>						
<b>Swaps long:</b>						
2008 (crude oil and refined products)	8,364	15.48	21.45	N/A	50	50
2009 (crude oil and refined products)	750	141.21	151.59	N/A	8	8
<b>Swaps short:</b>						
2008 (crude oil and refined products)	8,379	21.79	15.92	N/A	(49)	(49)
2009 (crude oil and refined products)	750	156.68	145.45	N/A	(8)	(8)
<b>Futures long:</b>						
2008 (crude oil and refined products)	15,595	139.77	N/A	2,180	2,338	158
2009 (crude oil and refined products)	1,852	112.19	N/A	208	261	53
2008 (natural gas)	1,350	12.47	N/A	17	18	1

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			<b>June 30, 2008</b>			
	<b>Contract Volumes</b>	<b>Wtd Avg Pay Price</b>	<b>Wtd Avg Receive Price</b>	<b>Contract Value</b>	<b>Market Value</b>	<b>Pre-tax Fair Value</b>
<b>Futures short:</b>						
2008 (crude oil and refined products)	15,595	N/A	\$ 137.95	\$ 2,151	\$ 2,326	\$ (175)
2009 (crude oil and refined products)	1,852	N/A	109.31	202	262	(60)
2008 (natural gas)	1,350	N/A	12.69	17	18	(1)
<b>Total pre-tax fair value of open positions</b>						<b>\$ (352)</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>						<b>\$ (45)</b>





**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 June 30, 2008 and December 31, 2007.

	June 30, 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	\$ 6,518
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 June 30, 2008, we had commitments to purchase \$829 million of U.S. dollars. These contracts matured on or before July 29, 2008, resulting in a \$6 million loss in the third 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 effective as of June 30, 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.

**Table of Contents****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 or our quarterly report on Form 10-Q for the quarter ended March 31, 2008.

***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.

*United States Department of Justice (DOJ)/ United States Environmental Protection Agency (EPA) (Corpus Christi West Refinery)* (this matter was last reported in our Form 10-K for the year ended December 31, 2007). In June 2008, we agreed with the DOJ and EPA on a \$1.65 million penalty to resolve alleged violations of the Clean Water Act resulting from an oil spill at our Corpus Christi West Refinery in June 2006.

*New Jersey Department of Environmental Protection (NJDEP) (Paulsboro Refinery)*. In the second quarter of 2008, the NJDEP issued an air-related Administrative Order and Notice of Civil Administrative Penalty Assessment (Notice) to our Paulsboro Refinery with a proposed penalty of \$317,900. The Notice covers certain deviations from permit and regulatory requirements that the refinery had self-reported in 2007. We are pursuing settlement of this Notice with the NJDEP.

*Oklahoma Department of Environmental Quality (ODEQ) (Ardmore Refinery)*. In June 2008, the ODEQ issued a penalty demand of \$196,166 for alleged excess air emission violations at our Ardmore Refinery occurring in 2006 and 2007. We are in settlement discussions with the ODEQ to resolve this matter.

*State of Ohio, Office of the Attorney General, Environmental Enforcement* (The Premcor Refining Group Inc. former Clark Retail Enterprises, Inc. retail sites). In June 2008, the Attorney General's office of the State of Ohio issued a penalty demand of \$11,133,000 to our wholly owned subsidiary, The Premcor Refining Group Inc., for alleged environmental violations arising from a predecessor's operation or ownership of underground storage tanks at several sites. We are in settlement discussions with the Ohio Attorney General to resolve this matter.

**Table of Contents****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.

**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 Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Not Purchased as Part of Publicly Announced Plans or Programs (1)	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs (at month end) (2)
April 2008	536	\$49.55	536	-	\$3.85 billion
May 2008	3,132,830	\$48.32	550,626	2,582,204	\$3.72 billion
June 2008	631,263	\$49.07	1,263	630,000	\$3.69 billion
Total	3,764,629	\$48.44	552,425	3,212,204	\$3.69 billion

(1) The shares reported in this column represent purchases settled in the second 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. This program is in addition to the \$6 billion program. This new \$3 billion program has no expiration date.

**Table of Contents****Item 4. Submission of Matters to a Vote of Security Holders.**

Valero's annual meeting of stockholders (the Annual Meeting) was held May 1, 2008. Matters voted on at the Annual Meeting and the results thereof were as follows:

- (a) Proposal 1: a proposal to elect three Class II directors to serve until the 2011 annual meeting. Valero's bylaws require each director to be elected by the vote of the majority of the votes cast at the Annual Meeting. For purposes of this election, a majority of the votes cast means that the number of shares voted for a director's election exceeds 50% of the number of votes cast with respect to that director's election. With respect to each nominee, votes cast includes votes to withhold authority but excludes abstentions. The election of each Class II director was approved as follows.

Directors	For	Withheld
W.E. Bill Bradford Ronald K. Calgaard	455,897,160	14,751,018
Irl F. Engelhardt	452,573,477 456,141,090	18,074,700 14,507,088

Directors whose terms of office continued after the annual meeting were: Jerry D. Choate, Ruben M. Escobedo, William R. Klesse, Robert Marbut, Donald L. Nickles, Robert A. Profusek, and Susan Kaufman Purcell.

- (b) Proposal 2: a proposal to ratify the appointment of KPMG LLP to serve as Valero's independent registered public accounting firm for the fiscal year ending December 31, 2008. Proposal 2 required approval by the affirmative vote of a majority of the voting power of the shares present in person or by proxy at the Annual Meeting and entitled to vote. Proposal 2 was approved as follows:

For	Against	Abstain <sup>(1)</sup>	Non-Votes <sup>(2)</sup>
462,292,127	4,229,282	4,126,767	n/a
Total Affirmative Votes 462,292,127	Total Negative Votes 8,356,049		
Percentage of Shares Present and Entitled to Vote 98.22%	Percentage of Shares Present and Entitled to Vote 1.78%		

**Stockholder Proposals:**

- (c) Proposal 3: a stockholder proposal entitled, "Prohibition of Executive Officer Stock Sales During Stock Repurchase Periods" was not approved as follows:

For	Against	Abstain <sup>(1)</sup>	Non-Votes <sup>(2)</sup>
21,705,465	369,391,902	4,672,066	74,878,744
Total Affirmative Votes 21,705,465	Total Negative Votes 374,063,968		
Percentage of Shares Present and Entitled to Vote	Percentage of Shares Present and Entitled to Vote		

5.48%

94.52%

(1) (2) See notes on following page.

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(d) Proposal 4: a stockholder proposal entitled, Stockholder Ratification of Executive Compensation was not approved as follows:

For	Against	Abstain <sup>(1)</sup>	Non-Votes <sup>(2)</sup>
167,728,593	144,840,314	83,201,521	74,877,749
Total Affirmative Votes 167,728,593	Total Negative Votes 228,041,835		
Percentage of Shares Present and Entitled to Vote 42.38%	Percentage of Shares Present and Entitled to Vote 57.62%		

(e) Proposal 5: a stockholder proposal entitled, Disclosure of Corporate Political Contributions was not approved as follows:

For	Against	Abstain <sup>(1)</sup>	Non-Votes <sup>(2)</sup>
106,579,440	169,069,500	120,120,494	74,878,743
Total Affirmative Votes 106,579,440	Total Negative Votes 289,189,994		
Percentage of Shares Present and Entitled to Vote 26.93%	Percentage of Shares Present and Entitled to Vote 73.07%		

*Required votes.* For Proposal 1, directors were to be elected by a majority of votes cast by the holders of shares of Valero's common stock present in person or by proxy at the Annual Meeting and entitled to vote. Proposals 2, 3, 4, and 5 required approval by the affirmative vote of a majority of the voting power of the shares present in person or by proxy at the Annual Meeting and entitled to vote. Only Proposals 1 and 2 received the required votes for approval.

**Notes:**

(1) *Effect of abstentions.* Shares voted to abstain are treated as present for purposes of determining a quorum, and have the effect of a negative vote when approval for a proposal requires a majority of the voting power of the issued and outstanding shares of the company or a majority of the voting power of the shares present in person or by proxy and entitled to vote.

(2) *Effect of broker non-votes.* Brokers holding shares for the beneficial owners of such shares must vote according to specific instructions received from the beneficial owners. If specific instructions are not received, a broker may vote the shares in the broker's discretion in certain instances. However, the New York Stock Exchange (NYSE) precludes brokers from exercising voting discretion on certain proposals, including stockholder proposals, without specific instructions from the beneficial owner. This results in a broker non-vote on the proposal. A broker non-vote is treated as present for purposes of determining a quorum, has the effect of a negative vote when approval for a particular proposal requires a majority of the voting power of the issued and outstanding shares of the company, and has no effect when approval for a proposal requires a majority of the voting power of the shares present in person or by proxy and entitled to vote. Per the NYSE's rules, brokers had discretion to vote on Proposals 1 and 2 at the Annual Meeting, but did not have discretion to vote on the shareholder proposals presented as Proposals 3, 4, and 5.





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**Item 6. Exhibits.**

<u>Exhibit No.</u>	<u>Description</u>
*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) Certification (under Section 302 of the Sarbanes-Oxley Act of 2002) of principal executive officer.
*31.02	Rule 13a-14(a) Certification (under Section 302 of the Sarbanes-Oxley Act of 2002) of principal financial officer.
*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: August 8, 2008