

VALERO ENERGY CORP/TX
Form 10-Q/A
May 10, 2005

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q/A
(Amendment No. 1)

(Mark One)

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2005

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 an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).
Yes No ___

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The number of shares of the registrant's only class of common stock, \$0.01 par value, outstanding as of April 29, 2005 was 256,732,665.

Explanatory Note

This amendment to the Company's Quarterly Report on Form 10-Q for the quarter ended March 31, 2005 is being filed solely to include the conformed signature of the Registrant, which was inadvertently omitted from the Form 10-Q filed on May 10, 2005. No revisions have been made to the Registrant's financial statements or any other disclosure contained in such Form 10-Q.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

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PART I - FINANCIAL INFORMATION**Item 1. Financial Statements****VALERO ENERGY CORPORATION AND SUBSIDIARIES****CONSOLIDATED BALANCE SHEETS****(Millions of Dollars, Except Par Value)**

	March 31, 2005	December 31, 2004
	<u>(Unaudited)</u>	
ASSETS		
Current assets:		
Cash and temporary cash investments	\$ 686	\$ 864
Restricted cash	24	24
Receivables, net	2,153	1,839
Inventories	2,801	2,318
Deferred income taxes	149	175
Prepaid expenses and other	43	44
	<u>5,856</u>	<u>5,264</u>
Total current assets		
Property, plant and equipment, at cost	12,680	12,295
Accumulated depreciation	(2,095)	(1,978)
	<u>10,585</u>	<u>10,317</u>
Property, plant and equipment, net		
Intangible assets, net	303	311
Goodwill	2,401	2,401
Investment in Valero L.P.	263	265
Deferred charges and other assets, net	906	834
	<u>20,314</u>	<u>19,392</u>
Total assets	\$	\$
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	\$ 435	\$ 412

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Accounts payable	3,914	2,963
Accrued expenses	690	519
Taxes other than income taxes	381	480
Income taxes payable	127	160
	<hr/>	<hr/>
Total current liabilities	5,547	4,534
	<hr/>	<hr/>
Long-term debt, less current portion	3,576	3,893
	<hr/>	<hr/>
Capital lease obligations, less current portion	34	8
	<hr/>	<hr/>
Deferred income taxes	1,974	2,011
	<hr/>	<hr/>
Other long-term liabilities	1,192	1,148
	<hr/>	<hr/>
Commitments and contingencies (Note 14)		
Stockholders' equity:		
Preferred stock, \$0.01 par value; 20,000,000 shares authorized; 9,072,488 and 10,000,000 shares issued and outstanding	190	208
Common stock, \$0.01 par value; 600,000,000 shares authorized; 262,107,776 and 261,188,614 shares issued	3	3
Additional paid-in capital	4,373	4,358
Treasury stock, at cost; 6,852,739 and 5,712,762 shares	(317)	(199)
Retained earnings	3,709	3,199
Accumulated other comprehensive income	33	229
	<hr/>	<hr/>
Total stockholders' equity	7,991	7,798
	<hr/>	<hr/>
Total liabilities and stockholders' equity	\$ 20,314	\$ 19,392
	<hr/>	<hr/>

See Condensed Notes to Consolidated Financial Statements.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Millions of Dollars, Except per Share Amounts and Supplemental Information)

(Unaudited)

	Three Months Ended March 31,	
	2005	2004
Operating revenues (1) (2)	\$ 14,953	\$ 11,082
Costs and expenses:		
Cost of sales (1)	13,072	9,759
Refining operating expenses	591	497
Retail selling expenses	175	165
General and administrative expenses	83	83
Depreciation and amortization expense	186	141
Total costs and expenses	14,107	10,645
Operating income	846	437
Equity in earnings of Valero L.P.	9	10
Other expense, net	(2)	
Interest and debt expense:		
Incurred	(74)	(71)
Capitalized	11	9
Income before income tax expense	790	385
Income tax expense	256	137
Net income	534	248
Preferred stock dividends	4	3
Net income applicable to common stock	\$ 530	\$ 245
Earnings per common share	\$ 2.07	\$ 0.97

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Weighted-average common shares outstanding (in millions)		256		252
Earnings per common share assuming dilution	\$	1.92	\$	0.91
Weighted-average common equivalent shares outstanding (in millions)		278		272
Dividends per common share	\$	0.08	\$	0.06
<hr/>				
Supplemental information (billions of dollars):				
(1) Includes amounts related to crude oil buy/sell arrangements:				
Operating revenues	\$	1.2	\$	0.9
Cost of sales		1.2		0.9
(2) Includes excise taxes on sales by Valero's U.S. retail system				
		0.2		0.2

See Condensed Notes to Consolidated Financial Statements.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Millions of Dollars)

(Unaudited)

	Three Months Ended March 31,	
	2005	2004
Cash flows from operating activities:		
Net income	\$ 534	\$ 248
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	186	141
Deferred income tax expense	102	98
Changes in current assets and current liabilities	(14)	(82)
Changes in deferred charges and credits and other, net	(11)	(76)
	<u>797</u>	<u>329</u>
Net cash provided by operating activities		
Cash flows from investing activities:		
Capital expenditures	(338)	(246)
Deferred turnaround and catalyst costs	(107)	(120)
Buyout of assets under structured lease arrangements		(567)
Aruba Acquisition, net of cash acquired		(567)
Contingent payments in connection with acquisitions	(50)	(9)
Minor acquisition and other investing activities, net	(34)	5
	<u>(529)</u>	<u>(1,504)</u>
Net cash used in investing activities		
Cash flows from financing activities:		
Long-term debt borrowings, net of issuance costs	35	2,520
Long-term debt repayments	(313)	(1,909)
Proceeds from the sale of common stock, net of issuance costs		406
Issuance of common stock in connection with employee benefit plans	33	61
Common and preferred stock dividends	(22)	(17)
Purchase of treasury stock	(177)	(12)
	<u>(444)</u>	<u>1,049</u>
Net cash provided by (used in) financing activities		

	_____	_____
Effect of foreign exchange rate changes on cash	(2)	(4)
	_____	_____
Net decrease in cash and temporary cash investments	(178)	(130)
Cash and temporary cash investments at beginning of period	864	369
	_____	_____
Cash and temporary cash investments at end of period	\$ 686	\$ 239
	_____	_____

See Condensed Notes to Consolidated Financial Statements.

338

\$

245

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 term Valero may refer to Valero Energy Corporation, one or more of its consolidated subsidiaries, or all of them taken as a whole.

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

These unaudited consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and notes required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal recurring nature unless disclosed otherwise. Financial information for the three months ended March 31, 2005 and 2004 included in these Condensed Notes to Consolidated Financial Statements is derived from Valero's unaudited consolidated financial statements. Operating results for the three months ended March 31, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

The consolidated balance sheet as of December 31, 2004 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 Valero's Annual Report on Form 10-K for the year ended December 31, 2004.

All share and per share data (except par value) presented for periods in 2004 reflect the effect of a two-for-one stock split, which was effected in the form of a common stock dividend distributed on October 7, 2004.

Certain previously reported amounts have been reclassified to conform to the 2005 presentation.

2. ACCOUNTING PRONOUNCEMENTS

FASB Statement No. 123 (revised 2004)

In December 2004, the Financial Accounting Standards Board (FASB) issued Statement No. 123 (revised 2004), Share-Based Payment (Statement No. 123R), which will require the expensing of stock options. In April 2005, the Securities and Exchange Commission (SEC) amended Rule 4-01(a) of Regulation S-X to defer the required date for compliance with Statement No. 123R to the first interim or annual reporting period of the registrant's first fiscal year beginning on or after June 15, 2005 if the registrant is not a small business issuer. Valero intends to adopt Statement No. 123R on January 1, 2006, which complies with the amended Rule 4-01(a).

The adoption of Statement No. 123R's fair value method will reduce Valero's results of operations, but it will not impact Valero's overall financial position. The magnitude of the impact of adoption of Statement No. 123R cannot be predicted at this time because it will depend on levels of share-based incentive awards granted in the future. However, had Valero adopted Statement No. 123R in prior periods, the

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

impact of that standard would have approximated the impact of Statement No. 123 as described in Note 12.

Statement No. 123R also requires the benefits of tax deductions in excess of recognized compensation cost to be reported as a financing cash flow, rather than as an operating cash flow as required under current literature. This requirement will reduce cash flows from operating activities and increase cash flows from financing activities in periods after adoption. While Valero cannot estimate the magnitude of such amounts in the future because they depend on, among other things, when employees exercise stock options, the amounts of operating cash flows recognized for such excess tax deductions were \$19 million and \$21 million for the three months ended March 31, 2005 and 2004, respectively.

FASB Interpretation No. 47

In March 2005, the FASB issued Interpretation No. 47, *Accounting for Conditional Asset Retirement Obligations* (FIN 47). FIN 47 clarifies that the term *conditional asset retirement obligation* as used in FASB Statement No. 143, *Accounting for Asset Retirement Obligations*, refers to a legal obligation to perform an asset retirement activity in which the timing and/or method of settlement are conditional on a future event that may or may not be within the control of the entity. Since the obligation to perform the asset retirement activity is unconditional, FIN 47 provides that a liability for the fair value of a conditional asset retirement obligation should be recognized if that fair value can be reasonably estimated, even though uncertainty exists about the timing and/or method of settlement. FIN 47 also clarifies when an entity would have sufficient information to reasonably estimate the fair value of an asset retirement obligation under FASB Statement No. 143. FIN 47 is effective for fiscal years ending after December 15, 2005, and is not expected to affect Valero's financial position or results of operations.

3. ACQUISITIONS***Aruba Acquisition***

On March 5, 2004, Valero completed the purchase of El Paso Corporation's refinery located on the island of Aruba in the Caribbean Sea (Aruba Refinery), and related marine, bunkering and marketing operations (collectively, Aruba Acquisition). The final purchase price allocation was as follows (in millions):

Current assets	\$ 323	
Property, plant and equipment	498	
Current liabilities	(172))
Capital lease obligation, less current portion	(3))
Deferred income taxes	9	
Other long-term liabilities	(20))
		<hr/>
Total purchase price	635	
Less cash acquired	(94))
		<hr/>

Purchase price, excluding cash acquired \$ 541

Unaudited Pro Forma Financial Information

The following unaudited pro forma financial information assumes that the Aruba Acquisition occurred on January 1, 2004. This pro forma information assumes 15.6 million shares of common stock were sold and approximately \$36 million of debt was incurred in connection with the Aruba Acquisition on January 1, 2004.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The consolidated statements of income include the results of operations of the Aruba Acquisition commencing on March 5, 2004. As a result, information for the three months ended March 31, 2005 presented below represents actual results of operations.

The unaudited pro forma financial information is not necessarily indicative of the results of future operations (in millions, except per share amounts):

	Three Months Ended March 31,	
	2005	2004
Operating revenues	\$ 14,953	\$ 11,553
Operating income	846	422
Net income	534	232
Earnings per common share	2.07	0.88
Earnings per common share assuming dilution	1.92	0.83

4. INVENTORIES

Inventories consisted of the following (in millions):

	March 31, 2005	December 31, 2004
Refinery feedstocks	\$ 1,229	\$ 877
Refined products and blendstocks	1,320	1,200
Convenience store merchandise	93	84
Materials and supplies	159	157
Inventories	<u>\$ 2,801</u>	<u>\$ 2,318</u>

As of March 31, 2005 and December 31, 2004, the replacement cost of LIFO inventories exceeded their LIFO carrying amounts by approximately \$2.6 billion and \$1.2 billion, respectively.

5. INVESTMENT IN AND TRANSACTIONS WITH VALERO L.P.

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As of March 31, 2005 and December 31, 2004, Valero owned approximately 45.5% and 45.7%, respectively, of Valero L.P., a limited partnership that owns and operates crude oil and refined product pipeline, terminalling and storage tank assets. Financial information reported by Valero L.P. is summarized below (in millions):

	Three Months Ended March 31,	
	2005	2004
Revenues	\$ 57	\$ 52
Operating income	25	25
Net income	19	20

As of March 31, 2005 and December 31, 2004, Valero's receivables, net included \$3 million and \$4 million, respectively, from Valero L.P., representing amounts due for employee costs, insurance costs, operating expenses, administrative costs and rentals. As of both March 31, 2005 and December 31, 2004,

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VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Valero's accounts payable included \$19 million to Valero L.P., representing amounts due for pipeline tariffs, terminalling fees and tank rentals and fees.

Under a services agreement, Valero provides Valero L.P. with the corporate functions of legal, accounting, treasury, engineering, information technology and other services for an administrative services fee as prescribed by the services agreement. In addition, Valero charges Valero L.P. for employee costs related to operating and maintenance services performed on certain Valero L.P. assets, and Valero pays Valero L.P. certain fees under throughput, handling, terminalling and service agreements with Valero L.P. The following table summarizes the results of transactions with Valero L.P. (in millions):

	Three Months Ended March 31,	
	2005	2004
Fees and expenses charged by Valero to Valero L.P.	\$ 11	\$ 8
Fees and expenses charged to Valero by Valero L.P.	55	51

6. LONG-TERM DEBT

During January 2005, Valero repurchased \$40 million of its 7.375% notes due in March 2006 and \$42 million of its 6.125% notes due in April 2007 at a premium of \$4 million. In addition, during the first quarter of 2005, Valero made the following scheduled debt repayments:

\$46 million during February 2005 related to its 7.44% medium-term notes, and
 \$150 million during March 2005 related to its 8% medium-term notes.
 During the three months ended March 31, 2005, Valero borrowed and repaid \$35 million under its revolving bank credit facilities.

7. STOCKHOLDERS EQUITY***2% Mandatory Convertible Preferred Stock***

During February 2005, 927,512 shares of the preferred stock were converted into 919,162 shares of Valero common stock. During April 2005, 1,287,564 additional shares of the preferred stock were converted into 1,275,975 shares of Valero common stock.

On April 22, 2005, Valero's board of directors declared a dividend on the mandatory convertible preferred stock of \$0.125 per share payable on June 30, 2005 to holders of record at the close of business on June 29, 2005.

Common Stock Purchases

During the three months ended March 31, 2005 and 2004, Valero purchased 2.8 million and 0.4 million shares of its common stock at a cost of \$177 million and \$12 million, respectively, in connection with the administration of its employee benefit plans.

Common Stock Dividends

On April 22, 2005, Valero's board of directors declared a regular quarterly cash dividend of \$0.10 per common share payable June 15, 2005 to holders of record at the close of business on May 18, 2005. This represented a \$0.02 per share increase compared to the dividend declared in the first quarter of 2005.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

8. EARNINGS PER COMMON SHARE

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

	Three Months Ended March 31,	
	2005	2004
Earnings per Common Share:		
Net income	\$ 534	\$ 248
Preferred stock dividends	4	3
	<u>530</u>	<u>245</u>
Net income applicable to common stock	\$ 530	\$ 245
	<u>530</u>	<u>245</u>
Weighted-average common shares outstanding	256	252
	<u>256</u>	<u>252</u>
Earnings per common share	\$ 2.07	\$ 0.97
	<u>2.07</u>	<u>0.97</u>
Earnings per Common Share Assuming Dilution:		
Net income applicable to common equivalent shares	\$ 534	\$ 248
	<u>534</u>	<u>248</u>
Weighted-average common shares outstanding	256	252
Effect of dilutive securities:		
Stock options	10	7
Performance awards and other benefit plans	3	3
Mandatory convertible preferred stock	9	10
	<u>278</u>	<u>272</u>
Weighted-average common equivalent shares outstanding	278	272
	<u>278</u>	<u>272</u>
Earnings per common share assuming dilution	\$ 1.92	\$ 0.91
	<u>1.92</u>	<u>0.91</u>

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. STATEMENTS OF CASH FLOWS

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

	Three Months Ended March 31,	
	2005	2004
Decrease (increase) in current assets:		
Restricted cash	\$	\$ 9
Receivables, net	(323)	(308)
Inventories	(479)	(345)
Prepaid expenses and other	2	(2)
Increase (decrease) in current liabilities:		
Accounts payable	950	606
Accrued expenses	(58)	(26)
Taxes other than income taxes	(97)	11
Income taxes payable	(9)	(27)
Changes in current assets and current liabilities	\$ (14)	\$ (82)

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;
the amounts shown above exclude the current assets and current liabilities acquired in connection with the Aruba Acquisition in 2004, which are reflected separately in the consolidated statement of cash flows, and the effect of certain noncash investing activities discussed below; and
certain differences between consolidated balance sheet changes and consolidated statement of cash flow changes reflected above result from translating foreign currency denominated amounts at different exchange rates.

Noncash investing activities for the three months ended March 31, 2005 included adjustments to property, plant and equipment and certain current and noncurrent assets and liabilities resulting from adjustments to the purchase price allocation related to the Aruba Acquisition.

Noncash financing activities for the three months ended March 31, 2005 included:

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the recognition of a \$28 million capital lease obligation and related capital lease asset related to certain equipment at Valero's Texas City Refinery and

the conversion of 927,512 shares of preferred stock into 919,162 shares of Valero common stock as discussed in Note 7.

There were no significant noncash investing or financing activities for the three months ended March 31, 2004.

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VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	Three Months Ended March 31,	
	2005	2004
Interest paid (net of amount capitalized)	\$ 18	\$ 22
Income taxes paid	165	73
Income tax refunds received	1	2

10. PRICE RISK MANAGEMENT ACTIVITIES

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

	Three Months Ended March 31,	
	2005	2004
Fair value hedges	\$ 1	\$ 3
Cash flow hedges	(2)	(7)

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 currently reported in accumulated other comprehensive income in the consolidated balance sheets will be reclassified into income when the forecasted transactions affect income. During the three months ended March 31, 2005, Valero recognized in accumulated other comprehensive income unrealized after-tax losses of \$226 million on certain cash flow hedges, primarily related to forward sales of distillates and associated forward purchases of crude oil, with \$232 million of cumulative after-tax losses on cash flow hedges remaining in accumulated other comprehensive income as of March 31, 2005. Valero expects that all of these losses will be reclassified into income over the next nine months as a result of hedged transactions that are forecasted to occur. The amount ultimately realized in income, however, will differ as commodity prices change. For the three months ended March 31, 2005 and 2004, there were no amounts reclassified from accumulated other comprehensive income into income as a result of the discontinuance of cash flow hedge accounting.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

11. SEGMENT INFORMATION

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

	<u>Refining</u>	<u>Retail</u>	<u>Corporate</u>	<u>Total</u>
Three months ended March 31, 2005:				
Operating revenues from external customers	\$ 13,366	\$ 1,587	\$	\$ 14,953
Intersegment revenues	1,042			1,042
Operating income (loss)	933	10	(97)	846
Three months ended March 31, 2004:				
Operating revenues from external customers	9,666	1,416		11,082
Intersegment revenues	838			838
Operating income (loss)	495	34	(92)	437

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

	<u>March 31,</u>	<u>December 31,</u>
	<u>2005</u>	<u>2004</u>
Refining	\$ 17,229	\$ 16,068
Retail	1,759	1,706
Corporate	1,326	1,618
Total consolidated assets	\$ 20,314	\$ 19,392

The entire balance of goodwill as of March 31, 2005 and December 31, 2004 has been included in the total assets of the refining reportable segment.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

12. STOCK-BASED COMPENSATION

Valero accounts for its employee stock compensation plans using the intrinsic value method of accounting set forth in APB Opinion No. 25, Accounting for Stock Issued to Employees, and related interpretations as permitted by Statement No. 123, Accounting for Stock-Based Compensation.

Because Valero accounts for its employee stock compensation plans using the intrinsic value method, compensation cost is not recognized in the consolidated statements of income for Valero's fixed stock option plans as all options granted have an exercise price equal to the market value of the underlying common stock on the date of grant. Had compensation cost for Valero's fixed stock option plans been determined based on the grant-date fair value of awards consistent with the alternative method set forth in Statement No. 123, Valero's net income applicable to common stock, net income and earnings per common share, both with and without dilution, for the three months ended March 31, 2005 and 2004 would have been reduced to the pro forma amounts indicated below (in millions, except per share amounts):

	Three Months Ended March 31,	
	2005	2004
Net income applicable to common stock, as reported	\$ 530	\$ 245
Deduct: Compensation expense on stock options determined under fair value method for all awards, net of related tax effects	(4)	(4)
Pro forma net income applicable to common stock	<u>\$ 526</u>	<u>\$ 241</u>
Earnings per common share:		
As reported	\$ 2.07	\$ 0.97
Pro forma	2.05	0.96
Net income, as reported	\$ 534	\$ 248
Deduct: Compensation expense on stock options determined under fair value method for all awards, net of related tax effects	(4)	(4)
Pro forma net income	<u>\$ 530</u>	<u>\$ 244</u>
Earnings per common share assuming dilution:		
As reported	\$ 1.92	\$ 0.91
Pro forma	1.91	0.90

See Note 2 for a discussion of FASB Statement No. 123 (revised 2004) and the SEC's amended Rule 4-01(a) of Regulation S-X, which will require Valero to change its accounting for stock-based compensation beginning in 2006.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

13. EMPLOYEE BENEFIT PLANS

The components of net periodic benefit cost related to Valero's defined benefit plans were as follows for the three months ended March 31, 2005 and 2004 (in millions):

	Pension Plans		Other Postretirement Benefit Plans	
	2005	2004	2005	2004
Components of net periodic benefit cost:				
Service cost	\$ 16	\$ 14	\$ 2	\$ 2
Interest cost	14	12	4	4
Expected return on plan assets	(12)	(10)		
Amortization of:				
Prior service cost	1		(2)	(2)
Net loss	2	1	2	2
Net periodic benefit cost	\$ 21	\$ 17	\$ 6	\$ 6

Valero's anticipated contributions to its pension plans during 2005 have not changed from amounts previously disclosed in Valero's consolidated financial statements for the year ended December 31, 2004. Valero has no minimum required contributions to its pension plans during 2005 under the Employee Retirement Income Security Act. For the three months ended March 31, 2005 and 2004, Valero contributed \$12 million and \$25 million, respectively, to its qualified pension plans.

14. COMMITMENTS AND CONTINGENCIES

Accounts Receivable Sales Facility

As of March 31, 2005, Valero had an accounts receivable sales facility with three third-party financial institutions to sell on a revolving basis up to \$600 million of eligible trade and credit card receivables, which matures in October 2005. As of March 31, 2005 and December 31, 2004, the amount of eligible receivables sold to the third-party financial institutions was \$600 million.

Guarantees

In connection with the sale of the Golden Eagle Business in 2002, Valero guaranteed certain lease payment obligations related to a lease assumed by Tesoro Refining and Marketing Company, which totaled approximately \$34 million as of March 31, 2005. This lease expires in 2010. To date, Valero has not been required to, and has not, made any payments under this guarantee.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Contingent Earn-Out Agreements

In January 2005, Valero made a previously accrued earn-out payment related to the acquisition of the St. Charles Refinery of \$50 million. No earn-out payments were made during the three months ended March 31, 2004. The following table summarizes the aggregate payments made and payment limitations for the following acquisitions (in millions):

	Basis Petroleum, Inc.	St. Charles Refinery
	_____	_____
Aggregate payments made through March 31, 2005	\$ 139	\$ 50
Annual maximum limit	35	50
Aggregate limit	200	175

Environmental Matters

The Environmental Protection Agency's (EPA) Tier II Gasoline and Diesel Standards. The EPA's Tier II standards, adopted under the Clean Air Act, phase in limitations on the sulfur content of gasoline (which began in 2004) and diesel fuel sold to highway consumers (beginning in 2006). Most of Valero's refineries are being modified to comply with the Tier II gasoline and diesel standards. Valero believes that capital expenditures of approximately \$2 billion will be required through 2008 for its refineries to meet the Tier II specifications, of which approximately \$880 million has been spent through March 31, 2005. This estimate includes amounts related to projects at three Valero refineries to provide hydrogen necessary for removing sulfur from gasoline and diesel. Valero expects that its cost estimates will change as additional engineering is completed and progress is made toward construction of these various projects.

EPA's Section 114 Initiative. In 2000, the EPA issued to a majority of refiners operating in the United States a series of information requests pursuant to Section 114 of the Clean Air Act as part of an enforcement initiative. Valero received a Section 114 information request pertaining to all of its refineries owned at that time. Valero completed its response to the request, and it has not been named in any enforcement proceeding by the EPA. Several other refiners, however, have either reached global settlements with the EPA regarding this enforcement initiative or have been subject to enforcement proceedings by the EPA. Valero believes that it will be able to finalize a settlement with the EPA during 2005 applicable to all of its U.S. refineries. Valero expects to incur penalties and related expenses in connection with a potential settlement, but believes that any settlement penalties will be immaterial to its consolidated results of operations and financial position. In addition, Valero expects that a settlement of this matter will require significant capital improvements or changes in operating parameters, or both, at most of its refineries. However, Valero expects that most of the required capital improvements or changes in operating parameters will be consistent with many of its existing or forecasted strategic capital projects or emission reduction projects already planned for the next several years.

Houston/Galveston SIP. Valero's Houston and Texas City Refineries are located in the Houston/Galveston area, which is classified as severe nonattainment for compliance with the EPA's one-hour air-quality standard for ozone. In October 2001, the EPA approved a State Implementation Plan (SIP) to bring the Houston/Galveston area into compliance with the one-hour ozone standard by 2007. The EPA-approved plan was based on a requirement for industry sources to reduce emissions of nitrogen oxides (NOx) by 90% from a 1997-1999 average actual emissions baseline. Certain industry and business groups challenged the plan based on technical feasibility of the 90% NOx control and its effectiveness in achieving compliance with the ozone standard. In December 2002, the Texas Commission on Environmental Quality (TCEQ) adopted a revised approach for the Houston/Galveston

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

SIP. This alternative plan requires an 80% reduction in NOx emissions and a 64% reduction in so-called highly reactive volatile organic compounds (HRVOC). This alternative plan is subject to EPA review and approval. Valero will be required to install NOx and HRVOC control and monitoring equipment and implement certain operating practices by 2007 at its Houston and Texas City Refineries at a cost estimated by Valero to be approximately \$68 million based on the proposed TCEQ approach.

Litigation

Unocal

In 2002, Union Oil Company of California (Unocal) sued Valero alleging patent infringement. The complaint seeks a 5.75 cent per gallon royalty on all reformulated gasoline infringing on Unocal's '393 and '126 patents. These patents cover certain compositions of cleaner-burning gasoline. The complaint seeks treble damages for Valero's alleged willful infringement of Unocal's patents and Valero's alleged conduct to induce others to infringe the patents. In a previous lawsuit involving its '393 patent, Unocal prevailed against several major refiners, including Chevron Corporation and Texaco Inc., now ChevronTexaco Corporation (ChevronTexaco). On April 4, 2005, ChevronTexaco announced that it is acquiring Unocal. It is unclear at this time how the proposed acquisition, if completed, will affect the patent lawsuit against Valero.

In 2001, the Federal Trade Commission (FTC) began an antitrust investigation concerning Unocal's misconduct with a joint industry research group and regulators during the time that Unocal was prosecuting its patents at the U.S. Patent and Trademark Office (PTO). In 2003, the FTC filed a complaint against Unocal for antitrust violations. The FTC's complaint seeks an injunction against future '393 or '126 patent enforcement activity by Unocal against any person or entity with respect to gasoline to be sold in California. The trial for the FTC's antitrust charges against Unocal began before an administrative law judge (ALJ) on October 19, 2004. The evidence phase of the proceeding ended in January 2005. The deadline for final briefing was recently extended until July 2005 based on an unopposed motion filed by the FTC. The FTC's motion referenced ChevronTexaco's proposed acquisition of Unocal and suggested that the extension of time would enable the FTC to review issues relating to ChevronTexaco's acquisition of Unocal's patents and would also permit the FTC to discuss the possibility of resolving the FTC's ongoing litigation with Unocal. If there is no resolution, the ALJ will rule and the ALJ's decision will likely be appealed to the full Commission.

In addition to the FTC proceedings, the '393 and '126 patents are being reexamined by the PTO. The PTO has issued notices of rejection of all claims of each of these patents. These rejections are subject to additional proceedings, including administrative appeal by Unocal, followed by an appeal in federal district court or the court of appeals. Ultimate invalidation would preclude Unocal from pursuing claims based on the '393 or '126 patents.

Unocal's suit against Valero is indefinitely stayed as a result of the PTO reexamination proceedings. Notwithstanding the judgment against the other refiners in the previous litigation, Valero believes that it has several strong defenses to Unocal's lawsuit, including those arising from Unocal's misconduct, and Valero believes it will prevail in the lawsuit. However, due to the inherent uncertainty of litigation, it is reasonably possible that Valero will not prevail in the lawsuit, and an adverse result could have a material effect on Valero's results of operations and financial position. An estimate of the possible loss or range of loss from such an adverse result cannot reasonably be made.

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

MTBE Litigation

As of April 30, 2005, Valero was named as a defendant in 63 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. Valero is named in these suits together with many other refining industry companies. Valero is being sued primarily as a refiner and marketer of MTBE and gasoline containing MTBE. Valero does not own or operate gasoline station facilities in most of the geographic locations in which damage is alleged to have occurred. The suits generally seek individual, unquantified compensatory and punitive damages and attorneys' fees. All but one of these cases have been removed to federal court by the defendants and have been consolidated for pre-trial proceedings in the U.S. District Court for the Southern District of New York. Four of these cases have been selected by the court as focus cases for discovery and pre-trial motions. Activity in the non-focus cases is generally stayed pending certain determinations in the focus cases. Valero believes that it has strong defenses to these claims and is vigorously defending the cases. Valero believes that an adverse result in any one of these suits would not have a material effect on its results of operations or financial position. However, Valero believes that an adverse result in all or a substantial number of these cases could have a material effect on Valero's results of operations and financial position. An estimate of the possible losses or range of losses from an adverse result in all or substantially all of these cases cannot reasonably be made.

Other Litigation

Valero is also a party to additional claims and legal proceedings arising in the ordinary course of business. Valero believes it is unlikely that the final outcome of any of the claims or proceedings to which it is a party would have a material adverse effect on its financial position, results of operations or liquidity; however, due to the inherent uncertainty of litigation, the range of possible loss, if any, cannot be estimated with a reasonable degree of precision and there can be no assurance that the resolution of any particular claim or proceeding would not have an adverse effect on Valero's results of operations, financial position or liquidity.

15. SUBSEQUENT EVENT

On April 25, 2005, Valero announced a proposed merger of Premcor Inc. (Premcor, NYSE symbol PCO) into Valero. The boards of directors of Valero and Premcor have approved the terms of the proposed transaction. The completion of the merger is subject to approval by Premcor's shareholders as well as regulatory approvals. The transaction is expected to close by December 31, 2005.

Under the terms of the merger agreement, each outstanding share of Premcor common stock will, upon completion of the merger, be converted into the right to receive cash or Valero common stock at the shareholder's election, subject to proration per the terms of the merger agreement, so that 50% of the total Premcor shares (based on the number of Premcor shares outstanding at completion of the merger on a diluted basis under the treasury stock method) are acquired for cash, with the balance to be acquired for Valero common stock. Valero expects to pay the cash portion of the merger consideration from available cash and additional borrowings. In addition, Valero will assume Premcor's existing long-term debt, which totaled approximately \$1.8 billion as of March 31, 2005.

Premcor is an independent petroleum refiner and supplier of unbranded transportation fuels, heating oil, petrochemical feedstocks, petroleum coke and other petroleum products with all of its operations in the

VALERO ENERGY CORPORATION AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

United States. Premcor owns and operates refineries in Port Arthur, Texas; Lima, Ohio; Memphis, Tennessee; and Delaware City, Delaware, with a combined crude oil throughput capacity of approximately 790,000 barrels per day.

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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 the discussion below under the heading *Results of Operations Outlook*, contains certain estimates, predictions, projections, assumptions and other forward-looking statements (as defined in Section 27A of the Securities Act of 1933 and Section 21E of the Securities Exchange Act of 1934) that involve various risks and uncertainties. While these forward-looking statements, and any assumptions upon which they are based, are made in good faith and reflect Valero's current judgment regarding the direction of its business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, assumptions or other future performance suggested in this report. These forward-looking statements can generally be identified by the words anticipate, believe, expect, plan, intend, estimate, project, budget, forecast, will, 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 discounts, and operating expenses;
- anticipated levels of crude oil and refined product inventories;
- Valero's 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 Valero's 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 and other regulatory initiatives; and
- the effect of general economic and other conditions on refining and retail industry fundamentals.

Valero's forward-looking statements are based on its beliefs and assumptions derived from information available at the time the statements are made. 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 Valero's facilities or other facilities that could impair Valero's ability to produce and/or transport refined products or receive feedstocks;
- political 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 and other regulations at both the state and federal levels and in foreign countries;
- the level of foreign imports of refined products;

accidents or other unscheduled shutdowns affecting Valero's refineries, machinery, pipelines or equipment, or those of Valero's 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;
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;
the introduction or enactment of federal or state legislation which may adversely affect Valero's business or operations;
changes in the credit ratings assigned to Valero's 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 Valero's future results of operations and whether any forward-looking statements ultimately prove to be accurate. Valero's 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. Valero does not intend to update these statements unless it is required by the securities laws to do so.

All subsequent written and oral forward-looking statements attributable to Valero or persons acting on its behalf are expressly qualified in their entirety by the foregoing. Valero undertakes 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.

Overview

As of March 31, 2005, Valero, an independent refining and marketing company, owned and operated 15 refineries in the United States, Canada and Aruba with a combined throughput capacity, including crude oil and other feedstocks, of approximately 2.5 million barrels per day.

Valero markets refined products through an extensive bulk and rack marketing network and a network of more than 4,700 retail and wholesale branded outlets in the United States, Canada and Aruba under various brand names including primarily Valero®, Diamond Shamrock®, Shamrock®, Ultramar® and Beacon®. Valero's operations are affected by:

- company-specific factors, primarily refinery utilization rates and refinery maintenance turnarounds;
- seasonal factors, such as the demand for refined products; and
- industry factors, such as movements in and the level of crude oil prices including the effect of quality differential between grades of crude oil, the demand for and prices of refined products, industry supply capacity and competitor refinery maintenance turnarounds.

Valero's 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. Since approximately 70% of Valero's total crude oil throughput represents sour crude oil feedstocks, Valero's profitability is also significantly affected by the spread between sweet crude oil and sour crude oil prices, referred to as the sour crude oil discount. During the first quarter of 2005, the positive industry fundamentals experienced throughout 2004 continued. Sour crude oil discounts and distillate margins in the first quarter of 2005 significantly exceeded the sour crude oil discounts and distillate margins realized in the full year of 2004, which were then the best ever experienced by Valero.

The positive industry fundamentals combined with increased throughput volumes, particularly sour crude oil (primarily attributable to the full-quarter contribution from the Aruba Refinery's operations), resulted in net income for the first quarter of 2005 that was more than double Valero's net income for the first quarter of 2004. Valero reported net income of \$534 million, or \$1.92 per share, for the first quarter of 2005, compared to net income of \$248 million, or \$0.91 per share, for the first quarter of 2004. Valero increased the dividend on its common stock by 25% from \$0.08 per share to \$0.10 per share in the second quarter of 2005.

All share and per share data (except par value) for all prior periods presented in this Form 10-Q reflect the effect of the two-for-one common stock split which was distributed in the form of a stock dividend on October 7, 2004.

RESULTS OF OPERATIONS**First Quarter 2005 Compared to First Quarter 2004****Financial Highlights***(millions of dollars, except per share amounts)*

	Three Months Ended March 31,		
	2005	2004 (a)	Change
Operating revenues (b)	\$ 14,953	\$ 11,082	\$ 3,871
Costs and expenses:			
Cost of sales (b)	13,072	9,759	3,313
Refining operating expenses	591	497	94
Retail selling expenses	175	165	10
General and administrative expenses	83	83	
Depreciation and amortization expense:			
Refining	154	117	37
Retail	18	15	3
Corporate	14	9	5
Total costs and expenses	14,107	10,645	3,462
Operating income	846	437	409
Equity in earnings of Valero L.P.	9	10	(1)
Other expense, net	(2)		(2)
Interest and debt expense:			
Incurred	(74)	(71)	(3)
Capitalized	11	9	2
Income before income tax expense	790	385	405
Income tax expense	256	137	119
Net income	534	248	286
Preferred stock dividends	4	3	1
Net income applicable to common stock	\$ 530	\$ 245	\$ 285
Earnings per common share assuming dilution	\$ 1.92	\$ 0.91	\$ 1.01

See the footnote references on page 27.

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

	Three Months Ended March 31,		
	2005	2004 (a)	Change
Refining:			
Operating income	\$ 933	\$ 495	\$ 438
Throughput margin per barrel (c)	\$ 8.40	\$ 6.28	\$ 2.12
Operating costs per barrel:			
Refining operating expenses	\$ 2.96	\$ 2.81	\$ 0.15
Depreciation and amortization	0.77	0.67	0.10
Total operating costs per barrel	\$ 3.73	\$ 3.48	\$ 0.25
Throughput volumes (thousand barrels per day) (d):			
Feedstocks:			
Heavy sour crude	520	343	177
Medium/light sour crude	596	517	79
Acidic sweet crude	106	100	6
Sweet crude	545	552	(7)
Residuals	116	93	23
Other feedstocks	121	138	(17)
Total feedstocks	2,004	1,743	261
Blendstocks and other	216	196	20
Total throughput volumes	2,220	1,939	281
Yields (thousand barrels per day):			
Gasolines and blendstocks	1,009	997	12
Distillates	685	570	115
Petrochemicals	72	73	(1)
Other products (e)	464	309	155
Total yields	2,230	1,949	281
Retail U.S.:			
Operating income (loss)	\$ (15)	\$ 3	\$ (18)
Company-operated fuel sites (average)	1,036	1,137	(101)
Fuel volumes (gallons per day per site)	4,647	4,513	134
Fuel margin per gallon	\$ 0.068	\$ 0.095	\$ (0.027)
Merchandise sales	\$ 214	\$ 217	\$ (3)
Merchandise margin (percentage of sales)	29.2 %	28.8 %	0.4 %
Margin on miscellaneous sales	\$ 28	\$ 23	\$ 5

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Retail selling expenses	\$	122		\$	118		\$	4	
Depreciation and amortization expense	\$	13		\$	9		\$	4	
Retail Northeast:									
Operating income	\$	25		\$	31		\$	(6)
Fuel volumes (thousand gallons per day)		3,350			3,392			(42)
Fuel margin per gallon	\$	0.227		\$	0.233		\$	(0.006)
Merchandise sales	\$	33		\$	31		\$	2	
Merchandise margin (percentage of sales)		25.6	%		23.5	%		2.1	%
Margin on miscellaneous sales	\$	8		\$	5		\$	3	
Retail selling expenses	\$	53		\$	47		\$	6	
Depreciation and amortization expense	\$	5		\$	6		\$	(1)

See the footnote references on page 27.

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

	Three Months Ended March 31,		
	2005	2004 (a)	Change
Gulf Coast:			
Operating income	\$ 622	\$ 273	\$ 349
Throughput volumes (thousand barrels per day) (d)	1,253	1,007	246
Throughput margin per barrel (c)	\$ 8.98	\$ 6.56	\$ 2.42
Operating costs per barrel:			
Refining operating expenses	\$ 2.81	\$ 2.91	\$ (0.10)
Depreciation and amortization	0.66	0.67	(0.01)
Total operating costs per barrel	\$ 3.47	\$ 3.58	\$ (0.11)
Mid-Continent:			
Operating income	\$ 34	\$ 48	\$ (14)
Throughput volumes (thousand barrels per day)	291	289	2
Throughput margin per barrel (c)	\$ 5.13	\$ 4.99	\$ 0.14
Operating costs per barrel:			
Refining operating expenses	\$ 3.15	\$ 2.63	\$ 0.52
Depreciation and amortization	0.69	0.55	0.14
Total operating costs per barrel	\$ 3.84	\$ 3.18	\$ 0.66
Northeast:			
Operating income	\$ 71	\$ 122	\$ (51)
Throughput volumes (thousand barrels per day)	377	387	(10)
Throughput margin per barrel (c)	\$ 5.59	\$ 5.78	\$ (0.19)
Operating costs per barrel:			
Refining operating expenses	\$ 2.68	\$ 1.78	\$ 0.90
Depreciation and amortization	0.80	0.53	0.27
Total operating costs per barrel	\$ 3.48	\$ 2.31	\$ 1.17
West Coast:			
Operating income	\$ 206	\$ 52	\$ 154
Throughput volumes (thousand barrels per day)	299	256	43
Throughput margin per barrel (c)	\$ 12.67	\$ 7.41	\$ 5.26
Operating costs per barrel:			
Refining operating expenses	\$ 3.73	\$ 4.18	\$ (0.45)
Depreciation and amortization	1.27	0.98	0.29

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Total operating costs per barrel	\$	<u>5.00</u>	\$	<u>5.16</u>	\$	<u>(0.16)</u>
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See the footnote references on page 27.

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*Average Market Reference Prices and Differentials (g)**(dollars per barrel)*

	Three Months Ended March 31,		
	2005	2004	Change
Feedstocks:			
West Texas Intermediate (WTI) crude oil	\$ 49.70	\$ 35.24	\$ 14.46
WTI less sour crude oil at U.S. Gulf Coast (h)	8.06	3.73	4.33
WTI less Alaska North Slope (ANS) crude oil	4.85	1.09	3.76
WTI less Maya crude oil	17.08	9.38	7.70
Products:			
U.S. Gulf Coast:			
Conventional 87 gasoline less WTI	5.86	8.22	(2.36)
No. 2 fuel oil less WTI	7.36	2.65	4.71
Propylene less WTI	22.17	9.15	13.02
U.S. Mid-Continent:			
Conventional 87 gasoline less WTI	7.25	8.33	(1.08)
Low-sulfur diesel less WTI	9.24	4.09	5.15
U.S. Northeast:			
Conventional 87 gasoline less WTI	4.93	8.69	(3.76)
No. 2 fuel oil less WTI	9.34	4.02	5.32
Lube oils less WTI	26.15	24.31	1.84
U.S. West Coast:			
CARBOB 87 gasoline less ANS	19.12	16.55	2.57
Low-sulfur diesel less ANS	18.03	9.92	8.11

The following notes relate to references on pages 24 through 27.

- (a) Includes the operations related to the Aruba Acquisition commencing on March 5, 2004.
- (b) Operating revenues and cost of sales both include approximately \$1.2 billion for the three months ended March 31, 2005, and approximately \$0.9 billion for the three months ended March 31, 2004, related to certain crude oil buy/sell arrangements, which involve linked purchases and sales related to crude oil contracts entered into to address location, quality or grade requirements.
- (c) Throughput margin per barrel represents operating revenues less cost of sales divided by throughput volumes.
- (d) Total throughput volumes and throughput volumes for the Gulf Coast region for the three months ended March 31, 2005 and 2004, are based on 90 days and 91 days, respectively, which results in 225,000 barrels per day and 64,000 barrels per day being included for the Aruba Refinery for the first quarter of 2005 and 2004, respectively. Throughput volumes for the Aruba Refinery for the 27 days of its operations during the first quarter of 2004 averaged 216,000 barrels per day.
- (e) Other products primarily include gas oils, No. 6 fuel oil, petroleum coke and asphalt.
- (f) The Gulf Coast refining region includes the Corpus Christi East, Corpus Christi West, Texas City, Houston, Three Rivers, Krotz Springs, St. Charles and Aruba Refineries; the Mid-Continent refining region includes the McKee, Ardmore and Denver Refineries; the Northeast refining region includes the Quebec and Paulsboro Refineries; and the West Coast refining region includes the Benicia and Wilmington Refineries.
- (g) The average market reference prices and differentials, with the exception of the propylene and lube oil differentials, are based on posted prices from Platt's 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

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- consolidated financial statements with economic indicators that significantly affect Valero's operations and profitability.
- (h) 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 35% for the first quarter of 2005 compared to the first quarter of 2004 primarily as a result of significantly higher refined product prices combined with additional throughput volumes from refinery operations. Operating income increased \$409 million, or 94%, from the first quarter of 2004 to the first quarter of 2005 due primarily to a \$438 million increase in the refining segment, partially offset by a \$24 million decrease in the retail segment.

Refining

Operating income for Valero's refining segment increased from \$495 million for the first quarter of 2004 to \$933 million for the first quarter of 2005, resulting from an increase in refining throughput margin of \$2.12 per barrel, or 34%, and a 14% increase in throughput volumes.

Refining total throughput margin for 2005 increased due to the following factors:

Discounts on Valero's sour crude oil feedstocks during the first quarter of 2005 improved significantly compared to the first quarter of 2004 due to ample supplies of sour crude oils and heavy sour residual fuel oils on the world market. In addition, discounts on sour crude oil feedstocks benefited from increased demand for sweet crude oil resulting from several factors, including (i) the global movement to cleaner fuels, which has required refineries to lower the sulfur content of the gasoline they produce, and (ii) a global increase in refined product demand, particularly in Asia, which has resulted in higher utilization rates by refineries that require sweet crude oil as feedstock.

Distillate margins increased significantly in all of Valero's refining regions in the first quarter of 2005 compared to the first quarter of 2004 due to increased foreign and U.S. demand, which resulted from improved economies and higher demand for on-road diesel.

Petrochemical feedstock margins improved in the first quarter of 2005 compared to the first quarter of 2004 due to increased demand for such feedstocks resulting from a stronger worldwide economy.

Throughput volumes increased 281,000 barrels per day in the first quarter of 2005 compared to the first quarter of 2004 primarily due to incremental throughput of 161,000 barrels per day at the Aruba Refinery, which was acquired in March 2004, and lower volumes in the first quarter of 2004 due to turnarounds at the St. Charles and Wilmington Refineries.

Partially offsetting the above increases in throughput margin were lower overall gasoline margins compared to the exceptionally strong gasoline margins that existed in the first quarter of 2004 and lower margins on other refined products such as petroleum coke, sulfur, No. 6 oil and asphalt due to a significant increase in the price of crude oil from the first quarter of 2004 to the first quarter of 2005. In addition, Valero's throughput margin in the first quarter of 2005 was negatively impacted by pre-tax losses of approximately \$75 million on hedges primarily related to forward sales of distillates and associated forward purchases of crude oil, the majority of which were entered into during 2004.

Refining operating expenses were 19% higher for the quarter ended March 31, 2005 compared to the quarter ended March 31, 2004, due primarily to a full quarter of operations of the Aruba Refinery and increases in energy costs, employee compensation expense, including variable compensation, and insurance expense. Although total refining operating expenses increased 19%, this increase was 5% on a per-barrel basis due to the increase in throughput volumes between the periods. Refining depreciation and amortization expense increased 32% from the first quarter of 2004 to the first quarter of 2005 due to additional depreciation expense resulting from the full-quarter effect of the Aruba Acquisition, implementation of new capital projects and increased turnaround and catalyst amortization.

Retail

Retail operating income was \$10 million for the quarter ended March 31, 2005 compared to \$34 million for the quarter ended March 31, 2004. The decrease was primarily attributable to lower U.S. retail fuel margins caused by rising crude oil prices, which could not be fully passed through to the consumer.

Corporate Expenses and Other

General and administrative expenses, including corporate depreciation and amortization expense, increased \$5 million for the quarter ended March 31, 2005 compared to the quarter ended March 31, 2004, primarily due to increases in employee compensation and benefits of approximately \$17 million between the quarters, mainly related to the recognition of increased variable compensation expense. This increase in employee compensation and benefits was partially offset by the successful resolution of a California excise tax dispute and reduced systems-related costs.

Income tax expense increased \$119 million from the first quarter of 2004 to the first quarter of 2005 mainly as a result of higher operating income. Valero's effective tax rate for the quarter ended March 31, 2005 decreased from the quarter ended March 31, 2004 due mainly to the Aruba Acquisition, the refining operations of which are non-taxable in Aruba through December 31, 2010.

OUTLOOK

Since the end of the first quarter of 2005, refining industry fundamentals have remained positive, resulting in a continuation of favorable refined product margins and sour crude oil discounts. Distillate margins, in particular, remain strong due to increasing global demand for on-road diesel and jet fuel attributable to strong global economic activity. Thus far during 2005, domestic gasoline demand has increased 1.5% compared to the same period in 2004.

Valero processes approximately 1.2 million barrels per day of sour crude oil and resid which sell at discounts to benchmark crude oils such as West Texas Intermediate. Sour crude oil discounts were wide during the month of April 2005 and are expected to remain favorable for an extended period of time. As global demand for crude oil has increased, the incremental barrel of crude oil that is produced to meet that increased demand is typically more sour and more heavy, leading to higher production of these lower-quality crude oils. Also, the global movement to lower-sulfur fuels has led to increased demand for sweet crude oils rather than sour crude oils. In addition, as global light product demand has grown, global refinery production rates have also increased, leading to higher production of residual fuel oil as a by-product of the refining process. Because resid can compete with certain heavy sour crude oils as a refinery feedstock, this also serves to widen the discounts for heavy sour crude oils.

Operationally, Valero expects to benefit during the remainder of 2005 from the completion of several turnaround and capital improvement projects, as well as additional strategic projects that will be completed during the remainder of 2005. As a result, throughput volumes for 2005 are expected to be approximately 100,000 barrels per day higher than 2004 levels. In addition, with the completion of various projects that will enable Valero to process heavier and more sour feedstocks, Valero will further strengthen its ability to take advantage of an expected continuation of favorable sour crude oil discounts.

LIQUIDITY AND CAPITAL RESOURCES

Cash Flows for the Three Months Ended March 31, 2005 and 2004

Net cash provided by operating activities for the three months ended March 31, 2005 was \$797 million compared to \$329 million for the three months ended March 31, 2004. The increase in cash generated

from operating activities was due primarily to the significant increase in operating income discussed above under Results of Operations, as well as lower cash required for working capital requirements and deferred charges and credits in the 2005 period. Changes in cash provided by or used for working capital during the first three months of 2005 and 2004 are shown in Note 9 of Condensed Notes to Consolidated Financial Statements. The primary changes for both quarters resulted from an increase in the level of Valero's inventories and an increase in commodity prices during each respective quarter.

The net cash generated from operating activities, combined with \$33 million of proceeds from the issuance of common stock related to Valero's benefit plans and approximately \$178 million of available cash on hand, were used to:

- fund \$445 million of capital expenditures and deferred turnaround and catalyst costs,
- make scheduled debt repayments of \$196 million and early debt repurchases of \$82 million,
- purchase 2.8 million shares of treasury stock at a cost of \$177 million,
- fund a contingent earn-out payment in connection with the St. Charles Acquisition of \$50 million,
- fund the acquisition of four asphalt terminals for \$35 million, and
- pay common and preferred stock dividends of \$22 million.

As discussed above, net cash provided by operating activities during the first three months of 2004 was \$329 million. The net cash provided by operations, combined with \$406 million of proceeds from the sale of common stock, approximately \$600 million of proceeds from the issuance of long-term debt, \$61 million of proceeds from the issuance of common stock related to Valero's benefit plans, and \$130 million of available cash on hand, were used mainly to:

- fund \$366 million of capital expenditures and deferred turnaround and catalyst costs,
- exercise options under structured lease arrangements to purchase \$567 million of leased property,
- fund the Aruba Acquisition, and
- pay common and preferred stock dividends of \$17 million.

Capital Investments

During the three months ended March 31, 2005, Valero expended \$338 million for capital expenditures and \$107 million for deferred turnaround and catalyst costs. Capital expenditures for the three months ended March 31, 2005 included approximately \$150 million of costs related to environmental projects.

In connection with Valero's acquisitions of Basis Petroleum, Inc. in 1997 and the St. Charles Refinery in 2003, the sellers are entitled to receive payments in any of the ten years and seven years, respectively, following these acquisitions if certain average refining margins during any of those years exceed a specified level. Any payments due under these earn-out arrangements are limited based on annual and aggregate limits. In January 2005, Valero made an earn-out payment of \$50 million related to the acquisition of the St. Charles Refinery. Based on actual margin levels for the twelve months ended April 30, 2005, \$35 million is due for the Basis Petroleum, Inc. acquisition for that twelve-month period and will be paid in May 2005. Based on actual margin levels through April 2005 and estimated margin levels through December 2005, the annual maximum limit of \$50 million for the St. Charles Refinery would be due for the year ending December 2005 and would be payable in early 2006.

For 2005, Valero expects to incur approximately \$2.0 billion for capital investments, including approximately \$1.7 billion for capital expenditures (approximately \$900 million of which is for environmental projects) and approximately \$300 million for deferred turnaround and catalyst costs. The capital expenditure estimate excludes anticipated expenditures related to the earn-out contingency agreements discussed above and strategic acquisitions. Valero continuously evaluates its capital budget and makes changes as economic conditions warrant.

In connection with Valero L.P.'s proposed merger with Kaneb Services LLC and Kaneb Pipe Line Partners, L.P., Valero expects to contribute approximately \$28 million to Valero L.P. to maintain Valero's 2% general partner interest in Valero L.P.

On April 25, 2005, Valero announced a proposed merger with Premcor, as further discussed in Note 15 of Condensed Notes to Consolidated Financial Statements.

Contractual Obligations

As of March 31, 2005, Valero's contractual obligations included long-term debt, capital lease obligations, operating leases and purchase obligations. Except as discussed below, there were no significant changes to Valero's contractual obligations during the three months ended March 31, 2005.

During January 2005, Valero repurchased \$40 million of its 7.375% notes due in March 2006 and \$42 million of its 6.125% notes due in April 2007 at a premium of \$4 million. In addition, during the first quarter of 2005, Valero made scheduled debt repayments of \$46 million during February 2005 related to its 7.44% medium-term notes and \$150 million during March 2005 related to its 8% medium-term notes.

As of March 31, 2005, current portion of long-term debt and capital lease obligations included \$214 million of notes which become due during the second and third quarters of 2005 and \$220 million of notes which become due during the first quarter of 2006.

As of March 31, 2005, Valero's short-term and long-term purchase obligations increased by approximately \$3 billion from the amount reported as of December 31, 2004. The increase is almost entirely attributable to an increase in obligations under crude oil supply contracts, resulting mainly from a significantly higher crude oil price as of March 31, 2005, and a new industrial gas contract entered into in the first quarter of 2005.

None of Valero's contractual obligations have rating agency triggers that would automatically require Valero to post additional collateral. However, in the event of certain downgrades of Valero's 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 Valero's bank credit facilities and other arrangements would increase. Following Valero's announcement of its proposed merger with Premcor on April 25, 2005, Standard & Poor's Ratings Services downgraded its rating of Valero's senior unsecured debt from BBB with a negative outlook to BBB minus and placed the rating on credit watch with negative implications. Also on April 25, 2005, Moody's Investors Service placed its rating of Valero's senior unsecured debt under review for possible downgrade.

Other Commercial Commitments

As of March 31, 2005, Valero's committed lines of credit included (in millions):

	Borrowing Capacity	Expiration
	<hr/>	<hr/>
3-year revolving credit facility	\$ 750	December 2006
5-year revolving credit facility	\$ 750	December 2006
Canadian revolving credit facility	Cdn. \$ 115	July 2005

As of March 31, 2005, Valero had \$306 million of letters of credit outstanding under its uncommitted short-term bank credit facilities, \$246 million of letters of credit outstanding under its committed facilities and Cdn. \$8 million of letters of credit outstanding under its Canadian facility.

As defined under Valero's revolving bank credit facilities, its debt-to-capitalization ratio (net of cash) was 29.6% as of March 31, 2005 compared to 30.7% as of December 31, 2004.

Other

Valero expects to contribute approximately \$60 million to its qualified pension plans during 2005, although no minimum contributions are required under the Employee Retirement Income Security Act. During the first three months of 2005, Valero contributed cash of \$12 million to its qualified pension plans.

Valero is 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 and characteristics and composition of gasolines and distillates. Because environmental laws and regulations are becoming more complex and stringent and new environmental laws and regulations are continuously being enacted or proposed, the level of future expenditures required for environmental matters could increase in the future. In addition, any major upgrades in any of Valero's refineries could require material additional expenditures to comply with environmental laws and regulations. For additional information regarding Valero's environmental matters, see Note 14 of Condensed Notes to Consolidated Financial Statements.

Valero believes it has sufficient funds from operations, and to the extent necessary, from the public and private capital markets and bank markets, to fund its ongoing operating requirements. Valero expects that, to the extent necessary, it can raise additional funds from time to time through equity or debt financings, including funds to finance the proposed merger with Premcor discussed in *Capital Investments* above. However, there can be no assurances regarding the availability of any future financings or whether such financings can be made available on terms acceptable to Valero.

OFF-BALANCE SHEET ARRANGEMENTS

Accounts Receivable Sales Facility

As of March 31, 2005, Valero had an accounts receivable sales facility with three third-party financial institutions to sell on a revolving basis up to \$600 million of eligible trade and credit card receivables, which matures in October 2005. As of March 31, 2005, the amount of eligible receivables sold to the third-party financial institutions was \$600 million.

Guarantees

In connection with the sale of the Golden Eagle Business in 2002, Valero guaranteed certain lease payment obligations related to a lease assumed by Tesoro Refining and Marketing Company, which totaled approximately \$34 million as of March 31, 2005. This lease expires in 2010. To date, Valero has not been required to, and has not, made any payments under this guarantee.

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. Valero's critical accounting policies are disclosed in its Annual Report on Form 10-K for the year ended December 31, 2004. No significant changes to Valero's accounting policies have occurred subsequent to December 31, 2004.

Item 3. Quantitative and Qualitative Disclosures About Market Risk

COMMODITY PRICE RISK

The following tables provide information about Valero's derivative commodity instruments as of March 31, 2005 and December 31, 2004 (dollars in millions, except for the weighted-average pay and receive prices as described below), including:

fair value hedges held to hedge refining inventories and unrecognized firm commitments,
cash flow hedges held to hedge forecasted feedstock and product purchases, refined product sales and natural gas purchases,
economic hedges held 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,
 and
trading activities held or issued for trading purposes.

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. The gain (loss) on swaps is equal to the fair value amount and represents the excess of the receive price over the pay price times the notional contract volumes. For futures and options, the gain (loss) represents (i) the excess of the fair value amount over the contract amount for long positions, or (ii) the excess of the contract amount over the fair 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 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.

As of March 31, 2005, Valero has approximately \$232 million of unrealized after-tax losses on certain cash flow hedge positions, primarily related to forward sales of distillates and associated forward purchases of crude oil, which are reflected in accumulated other comprehensive income. Valero expects that all of these losses will be reclassified into income during the remainder of 2005 as a result of hedged transactions that are forecasted to occur. The amount ultimately realized in income, however, will differ as commodity prices change.

March 31, 2005

	Contract Volumes	Wtd Avg Pay Price	Wtd Avg Receive Price	Contract Value	Fair Value	Gain (Loss)
Fair Value Hedges:						
Futures long:						
2005 (crude oil and refined products)	30,264	\$ 54.57	N/A	\$ 1,652	\$ 1,695	\$ 43
Futures short:						
2005 (crude oil and refined products)	41,816	N/A	\$ 54.87	2,294	2,345	(51)
Cash Flow Hedges:						
Swaps long:						
2005 (crude oil and refined products)	53,503	37.67	57.08	N/A	1,039	1,039
Swaps short:						
2005 (crude oil and refined products)	53,503	67.77	42.21	N/A	(1,367)	(1,367)
Futures long:						
2005 (crude oil and refined products)	9,556	48.64	N/A	465	569	104
Futures short:						
2005 (crude oil and refined products)	9,459	N/A	51.00	482	614	(132)
Economic Hedges:						
Swaps long:						
2005 (crude oil and refined products)	5,605	19.65	20.83	N/A	7	7
Swaps short:						
2005 (crude oil and refined products)	3,512	32.36	31.05	N/A	(5)	(5)
Futures long:						
2005 (crude oil and refined products)	23,599	60.63	N/A	1,431	1,471	40
2006 (crude oil and refined products)	15	60.29	N/A	1	1	
Futures short:						
2005 (crude oil and refined products)	25,229	N/A	60.66	1,530	1,586	(56)
Options long:						
2005 (crude oil and refined products)	1,600	7.28	N/A	(3)		3
Options short:						
2005 (crude oil and refined products)	4,626	N/A	8.16	1	21	(20)
Trading Activities:						
Swaps long:						
2005 (crude oil and refined products)	21,200	36.28	52.79	N/A	350	350
Swaps short:						
2005 (crude oil and refined products)	20,675	54.91	37.28	N/A	(365)	(365)
2006 (crude oil and refined products)	150	8.25	5.05	N/A		
Futures long:						

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2005 (crude oil and refined products)	21,441	53.48	N/A	1,147	1,275	128
Futures short:						
2005 (crude oil and refined products)	19,441	N/A	53.53	1,041	1,162	(121)
Options long:						
2005 (crude oil and refined products)	2,200	5.62	N/A	(1)		1
Options short:						
2005 (crude oil and refined products)	1,200	N/A	5.59		2	(2)

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December 31, 2004

	<u>Contract Volumes</u>	<u>Wtd Avg Pay Price</u>	<u>Wtd Avg Receive Price</u>	<u>Contract Value</u>	<u>Fair Value</u>	<u>Gain (Loss)</u>
Fair Value Hedges:						
Futures long:						
2005 (crude oil and refined products)	17,423	\$ 46.39	N/A	\$ 808	\$ 772	\$ (36)
Futures short:						
2005 (crude oil and refined products)	26,726	N/A	\$ 46.00	1,229	1,190	39
Cash Flow Hedges:						
Swaps long:						
2005 (crude oil and refined products)	67,378	37.05	42.84	N/A	390	390
Swaps short:						
2005 (crude oil and refined products)	67,378	48.54	41.65	N/A	(464)	(464)
Futures long:						
2005 (crude oil and refined products)	28,354	45.39	N/A	1,287	1,286	(1)
Futures short:						
2005 (crude oil and refined products)	23,152	N/A	45.95	1,064	1,067	(3)
Economic Hedges:						

Swaps							
long:							
2005							
(crude oil and refined products)	3,505	11.49	11.37	N/A			
Swaps							
short:							
2005							
(crude oil and refined products)	4,239	10.10	10.25	N/A	1		1
Futures							
long:							
2005							
(crude oil and refined products)	19,230	46.90	N/A	902	896		(6)
Futures							
short:							
2005							
(crude oil and refined products)	17,787	N/A	47.55	846	824		22
Options							
long:							
2005							
(crude oil and refined products)	1,000	35.00	N/A	3	5		2
Options							
short:							
2005							
(crude oil and refined products)	4,201	N/A	21.69	(2)	3		(5)
Trading Activities:							
Swaps							
long:							
2005							
(crude oil and refined products)	25,460	35.15	39.17	N/A	102		102
Swaps							
short:							
2005							
(crude oil and refined products)	23,585	42.66	38.20	N/A	(105)		(105)
Futures							
long:							
2005	15,956	45.09	N/A	719	725		6

2005 (crude oil and refined products)						
2005 (natural gas)	210	7.04	N/A	1	1	
Futures						
short:						
2005 (crude oil and refined products)	21,781	N/A	45.81	998	1,003	(5)
2005 (natural gas)	210	N/A	6.38	1	1	
Options						
long:						
2005 (crude oil and refined products)	1,550	48.35	N/A	1	1	
Options short:						
2005 (crude oil and refined products)	150		N/A	10.55		

INTEREST RATE RISK

The following table provides information about Valero's long-term debt and interest rate derivative instruments (dollars in millions), all of which are sensitive to changes in interest rates. For long-term debt, principal cash flows and related weighted-average interest rates by expected maturity dates are presented. For interest rate swaps, the table presents notional amounts and weighted-average interest rates by expected (contractual) maturity dates. Notional amounts are used to calculate the contractual payments to be exchanged under the contract. Weighted-average floating rates are based on implied forward rates in the yield curve at the reporting date.

March 31, 2005

		Expected Maturity Dates											
		2005	2006	2007	2008	2009	There- after	Total			Fair Value		
Long-term Debt:													
Fixed rate	\$	214	220	287	6	208	3,164	4,099			4,466		
Average interest rate		8.3 %	7.4 %	6.1 %	6.0 %	3.6 %	6.8 %	6.7 %					
Interest Rate Swaps													
Fixed to Floating:													
Notional amount	\$		125	225		8	642	1,000			(33)		
Average pay rate		5.5 %	6.3 %	6.1 %	5.9 %	6.0 %	6.0 %	6.0 %					
Average receive rate		6.0 %	6.0 %	5.8 %	5.7 %	5.7 %	5.6 %	5.7 %					

December 31, 2004

		Expected Maturity Dates											
		2005	2006	2007	2008	2009	There- after	Total			Fair Value		
Long-term Debt:													
Fixed rate	\$	410	260	329	6	208	3,164	4,377			4,790		

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Average interest rate	8.1	%	7.4	%	6.1	%	6.0	%	3.6	%	6.8	%	6.8	%
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Interest Rate Swaps

Fixed to

Floating:

Notional amount	\$		\$ 125		\$ 225		\$		\$ 8		\$ 642		\$ 1,000		\$ (15)
Average pay rate		5.0	%	5.6	%	5.6	%	5.4	%	5.8	%	6.2	%	5.9	%
Average receive rate		6.0	%	6.0	%	5.8	%	5.7	%	5.7	%	5.6	%	5.7	%

As of March 31, 2005 and December 31, 2004, Valero had no long-term floating-rate debt.

FOREIGN CURRENCY RISK

As of March 31, 2005, Valero had commitments to purchase approximately \$200 million of U.S. dollars. Valero's market risk was minimal on these contracts, as they matured on or before April 15, 2005.

As of March 31, 2005, Valero had entered into a foreign currency exchange contract which required Valero to purchase \$20 million of U.S. dollars. Valero's market risk was minimal on this contract as it matured in early April 2005.

As of March 31, 2005, Valero had also entered into a foreign currency exchange contract relating to the purchase of commercial paper, which required Valero to sell \$20 million of U.S. dollars in May 2005 at a

contract rate of 1.200035. The fair value of this contract as of March 31, 2005 approximated the contract value.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

Valero's management has evaluated, with the participation of Valero's principal executive and principal financial officers, the effectiveness of Valero's 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 Valero's disclosure controls and procedures were effective as of March 31, 2005 in ensuring that information required to be disclosed by Valero in the reports that it files or submits under the Exchange Act is recorded, processed, summarized and reported, within the time periods specified in the Securities and Exchange Commission's rules and forms.

(b) Changes in internal control over financial reporting.

There has been no change in Valero's internal control over financial reporting (as defined in Rule 13a-15(f) under the Exchange Act) that occurred during Valero's last fiscal quarter that has materially affected, or is reasonably likely to materially affect, Valero's internal control over financial reporting.

PART II OTHER INFORMATION**Item 1. Legal Proceedings.**

New Jersey Department of Environmental Protection (NJDEP) (Paulsboro Refinery) (this matter was last reported in Valero's Annual Report on Form 10-K for the year ended December 31, 2004). In April 2005, Valero finalized an administrative consent order with the NJDEP to settle 31 outstanding Administrative Orders and Notices of Civil Administrative Penalty Assessments (Orders) issued by NJDEP through March 2005 with respect to Valero's Paulsboro Refinery as well as several self-disclosed matters for which no Administrative Order had yet been issued. In the settlement, Valero agreed to pay \$793,800 in penalties to NJDEP and install several emissions controls at the refinery. Valero expects to spend approximately \$3.5 million to install a state-of-the-art cover on the refinery's oil-water separator to reduce emissions of volatile organic compounds from the unit by 95 percent. In the settlement, Valero also agreed to control emissions from the refinery's fuel gas system by the end of 2008, at an estimated cost of \$10 million. Valero also agreed to make certain changes in operations to reduce benzene emissions, for which Valero expects to spend approximately \$1.5 million. The settlement did not include the NJDEP's prior demands for stipulated penalties (totaling \$100,000 in the aggregate) relating to two alleged failures of a stack test required by an Administrative Consent Order entered in May 2000. Valero believes that it satisfied all requirements of the May 2000 Administrative Consent Order and intends to challenge the Department's demand for stipulated penalties in an administrative hearing.

Item 2. Unregistered Sales of Equity Securities and Use of Proceeds.

(c) *Issuer Purchases of Equity Securities.* The following table discloses purchases of shares of Valero's common stock made by or on behalf of Valero during the quarterly period covered by this report.

Period	Total Number of Shares Purchased (1)	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs (2)	Maximum Number (or Approximate Dollar Value) of Shares that May Yet Be Purchased Under the Plans or Programs
January 2005	459,600	\$ 47.08	0	\$ 361 million
February 2005	710,000	\$ 64.15	0	\$ 361 million
March 2005	1,473,550	\$ 69.01	0	\$ 361 million
Total	2,643,150	\$ 63.89	0	\$ 361 million

- (1) All of the reported shares were purchased in open-market transactions to satisfy Valero's obligations under its employee benefit plans and not through any publicly announced stock purchase plan or program.
- (2) Valero's existing stock repurchase program was publicly announced on December 3, 2001. The program authorizes Valero to purchase up to \$400 million aggregate purchase price of shares of Valero's common stock. The program has no expiration date.

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Item 6. Exhibits.

<u>Exhibit No.</u>	<u>Description</u>
2.01	Agreement and Plan of Merger dated as of April 24, 2005, between Valero Energy Corporation and Premcor Inc. - incorporated by reference to Exhibit 2.1 to Valero's Current Report on Form 8-K dated April 24, 2005, filed April 25, 2005.
*12.01	Statements of Computations of Ratios of Earnings to Fixed Charges and Ratios of Earnings to Fixed Charges and Preferred Stock Dividends.
*31.01	Rule 13a-14(a) Certifications (under Section 302 of the Sarbanes-Oxley Act of 2002).
*32.01	Section 1350 Certifications (as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).

* Filed herewith.

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SIGNATURE

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

VALERO ENERGY CORPORATION
(Registrant)

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

Date: May 10, 2005