VALERO ENERGY CORP/TX
Form 10-Q
November 07, 2007

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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q

(Mark One)

[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2007

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 X No__

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act. (Check one).

Large accelerated filer X Accelerated filer __ Non-accelerated filer __

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). Yes __ No X

The number of shares of the registrant s only class of common stock, $0.01 par value, outstanding as of October 31, 2007 was 550,436,386.

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)

	September 30, 2007 (Unaudited)	December 31, 2006
ASSETS		
Current assets:		
Cash and temporary cash investments	$ 3,109	$ 1,590
Restricted cash	31	31
Receivables, net	6,463	4,384
Inventories	4,616	3,979
Income taxes receivable	-	32
Deferred income taxes	197	143
Prepaid expenses and other	238	145
Assets held for sale	-	1,527
Total current assets	14,654	11,831
Property, plant and equipment, at cost	25,077	23,421
Accumulated depreciation	(3,853)	(3,241)
Property, plant and equipment, net	21,224	20,180
Intangible assets, net	298	303
Goodwill	4,061	4,103
Deferred charges and other assets, net	1,624	1,336
Total assets	$ 41,861	$ 37,753
LIABILITIES AND STOCKHOLDERS EQUITY		
Current liabilities:		
Current portion of long-term debt and capital lease obligations	$ 60	$ 475
Accounts payable	8,145	6,841
Accrued expenses	608	507
Taxes other than income taxes	612	584
Income taxes payable	494	23
Deferred income taxes	323	363
Liabilities related to assets held for sale	-	67
Total current liabilities	10,242	8,860
Long-term debt and capital lease obligations, less current portion	6,854	4,619

Deferred income taxes	3,941	4,047
Other long-term liabilities	1,856	1,622
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	7,366	7,779
Treasury stock, at cost; 79,121,102 and 23,738,162 common shares	(5,308)	(1,396)
Retained earnings	16,413	11,951
Accumulated other comprehensive income	491	265
Total stockholders equity	18,968	18,605
Total liabilities and stockholders equity	$ 41,861	$ 37,753

See Condensed Notes to Consolidated Financial Statements.

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Operating revenues (1)	$23,699	$23,238	$66,656	$68,805
Costs and expenses:				
Cost of sales	20,810	19,482	55,630	58,007
Refining operating expenses	1,036	889	2,955	2,684
Retail selling expenses	190	185	561	539
General and administrative expenses	152	136	474	458
Depreciation and amortization expense	343	285	1,002	819
Total costs and expenses	22,531	20,977	60,622	62,507
Operating income	1,168	2,261	6,034	6,298
Equity in earnings of NuStar Energy L.P.		13		35
Other income, net	145	143	157	138
Interest and debt expense:				
Incurred	(148)	(91)	(347)	(280)
Capitalized	25	45	83	126
Minority interest in net income of consolidated subsidiary		(4)		(4)
Income from continuing operations before income tax expense	1,190	2,367	5,927	6,313
Income tax expense	342	808	1,929	2,107
Income from continuing operations	848	1,559	3,998	4,206
Income from discontinued operations, net of income tax expense	426	44	669	143
Net income	1,274	1,603	4,667	4,349
Preferred stock dividends				2
Net income applicable to common stock	$ 1,274	$ 1,603	$ 4,667	$ 4,347
Earnings per common share:				
Continuing operations	$ 1.54	$ 2.56	$ 7.00	$ 6.85

Discontinued operations		0.77		0.07		1.17		0.23
Total	$	2.31	$	2.63	$	8.17	$	7.08
Weighted-average common shares outstanding (in millions)		551		609		571		613
Earnings per common share assuming dilution:								
Continuing operations	$	1.34	$	2.48	$	6.66	$	6.61
Discontinued operations		0.75		0.07		1.14		0.22
Total	$	2.09	$	2.55	$	7.80	$	6.83
Weighted-average common shares outstanding assuming dilution (in millions)		564		628		587		636
Dividends per common share	$	0.12	$	0.08	$	0.36	$	0.22
Supplemental information:								
(1) Includes excise taxes on sales by our U.S. retail system	$	207	$	197	$	606	$	587

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)

	Nine Months Ended September 30,	
	2007	**2006**
Cash flows from operating activities:		
Net income	$ 4,667	$ 4,349
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	1,019	847
Gain on sale of Lima Refinery	(827)	
Gain on sale of interest in NuStar GP Holdings, LLC		(132)
Stock-based compensation expense	58	70
Deferred income tax expense (benefit)	(75)	175
Changes in current assets and current liabilities	(880)	(129)
Changes in deferred charges and credits and other, net	44	(84)
Net cash provided by operating activities	4,006	5,096
Cash flows from investing activities:		
Capital expenditures	(1,553)	(2,331)
Deferred turnaround and catalyst costs	(338)	(464)
Proceeds from sale of interest in NuStar GP Holdings, LLC		355
Investment in Cameron Highway Oil Pipeline Company, net	(212)	(13)
Proceeds from sale of Lima Refinery	2,428	
Contingent payments in connection with acquisitions	(75)	(101)
Other investing activities, net	18	42
Net cash provided by (used in) investing activities	268	(2,512)
Cash flows from financing activities:		
Long-term notes:		
Borrowings	2,245	
Repayments	(413)	(249)
Bank credit agreements:		
Borrowings	3,000	707
Repayments	(3,000)	(706)
Termination of interest rate swaps		(54)
Purchase of treasury stock	(4,751)	(1,818)
Issuance of common stock in connection with employee benefit plans	130	103
Benefit from tax deduction in excess of recognized stock-based compensation cost	231	160
Common and preferred stock dividends	(205)	(136)
Other financing activities	(23)	(4)

Net cash used in financing activities	(2,786)	(1,997)
Effect of foreign exchange rate changes on cash	31	6
Net increase in cash and temporary cash investments	1,519	593
Cash and temporary cash investments at beginning of period	1,590	436
Cash and temporary cash investments at end of period	$ 3,109	$ 1,029

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 September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Net income	$ 1,274	$ 1,603	$ 4,667	$ 4,349
Other comprehensive income (loss):				
Foreign currency translation adjustment	90	(2)	251	70
Pension and other postretirement benefits net loss reclassified into income, net of income tax benefit of $1, $0, $3 and $0	1	-	4	-
Net gain (loss) on derivative instruments designated and qualifying as cash flow hedges:				
Net gain (loss) arising during the period, net of income tax (expense) benefit of $(37), $(17), $10 and $(18)	69	32	(18)	34
Net gain reclassified into income, net of income tax expense of $2, $1, $6 and $4	(4)	(2)	(11)	(8)
Net gain (loss) on cash flow hedges	65	30	(29)	26
Other comprehensive income	156	28	226	96
Comprehensive income	$ 1,430	$ 1,631	$ 4,893	$ 4,445

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 o 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 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 and nine months ended September 30, 2007 and 2006 included in these Condensed Notes to Consolidated Financial Statements is derived from our unaudited consolidated financial statements. Operating results for the three and nine months ended September 30, 2007 are not necessarily indicative of the results that may be expected for the year ending December 31, 2007.

The consolidated balance sheet as of December 31, 2006 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, 2006. As discussed in Note 3, the assets and liabilities of the Lima Refinery, as well as inventory to be sold by our marketing and supply subsidiary associated with this transaction, as of December 31, 2006 have been reclassified as held for sale, and the results of operations of the Lima Refinery have been presented as discontinued operations in the consolidated statements of income for all periods presented.

On December 22, 2006, we sold our remaining ownership interest in NuStar GP Holdings, LLC (formerly Valero GP Holdings, LLC), which indirectly owned the general partner interest, the incentive distribution rights, and a 21.4% limited partner interest in NuStar Energy L.P. (formerly Valero L.P.). As a result, our consolidated statements of income reflect no equity in earnings of NuStar Energy L.P. subsequent to December 21, 2006.

Reclassifications

Previously reported amounts have been reclassified to present the operations of the Lima Refinery as discontinued operations as discussed above. In addition, operating revenues, cost of sales, and retail selling expenses reported in our consolidated statements of income for 2006 have been reclassified for certain credit card transactions. Commencing January 1, 2007, fees received from our distributors and dealers associated with certain credit card transactions processed on behalf of those distributors and dealers are being netted against third-party processing costs incurred on such transactions to better reflect the nature of the credit card transactions. These credit card reclassifications increased (decreased) amounts previously reported in 2006 as follows (in millions):

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

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Operating revenues	$ (21)	$ (55)
Cost of sales	2	7
Retail selling expenses	(23)	(62)

2. ACCOUNTING PRONOUNCEMENTS

FASB Statement No. 155

In February 2006, the Financial Accounting Standards Board (FASB) issued Statement No. 155, Accounting for Certain Hybrid Financial Instruments, which amends Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This statement improves the financial reporting of certain hybrid financial instruments and simplifies the accounting for these instruments. In particular, Statement No. 155 (i) permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation, (ii) clarifies which interest-only and principal-only strips are not subject to the requirements of Statement No. 133, (iii) establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation, (iv) clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and (v) amends Statement No. 140 to eliminate the prohibition on a qualifying special-purpose entity holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument. The adoption of Statement No. 155 on January 1, 2007 has not affected our financial position or results of operations.

FASB Statement No. 156

In March 2006, the FASB issued Statement No. 156, Accounting for Servicing of Financial Assets, which amends Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Statement No. 156 requires the initial recognition at fair value of a servicing asset or servicing liability when an obligation to service a financial asset is undertaken by entering into a servicing contract. The adoption of Statement No. 156 on January 1, 2007 has not affected our financial position or results of operations.

FASB Interpretation No. 48

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertainty in income taxes recognized in an enterprise s financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes, by prescribing a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. If a tax position is more likely than not to be sustained upon examination, then an enterprise is required to recognize in its financial statements the largest amount of benefit that is greater than 50% likely of being realized upon ultimate settlement. The adoption of FIN 48 on January 1, 2007 did not materially affect our financial position or results of operations.

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

We have elected to classify any interest expense related to the underpayment of income taxes in income tax expense in our consolidated statements of income. Any penalties related to the underpayment of income taxes are recorded in the corresponding expense category in our consolidated statements of income.

EITF Issue No. 06-3

In June 2006, the FASB ratified its consensus on EITF Issue No. 06-3, How Taxes Collected from Customers and Remitted to Governmental Authorities Should Be Presented in the Income Statement (That Is, Gross versus Net Presentation) (EITF No. 06-3). The scope of EITF No. 06-3 includes any tax assessed by a governmental authority that is imposed concurrent with or subsequent to a revenue-producing transaction between a seller and a customer. For taxes within the scope of this issue that are significant in amount, the consensus requires the following disclosures: (i) the accounting policy elected for these taxes and (ii) the amount of the taxes reflected gross in the income statement on an interim and annual basis for all periods presented. The disclosure of those taxes can be provided on an aggregate basis. We adopted the consensus on January 1, 2007. We present excise taxes on sales by our U.S. retail system on a gross basis with supplemental information regarding the amount of such taxes included in revenues provided in a footnote on the face of the income statement. All other excise taxes are presented on a net basis in the income statement.

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. Statement No. 157 is effective for fiscal years beginning after November 15, 2007, with early adoption encouraged. 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. The adoption of Statement No. 157 is not expected to materially affect our financial position or results of operations.

FASB Statement No. 159

In February 2007, the FASB issued Statement No. 159, The Fair Value Option for Financial Assets and Financial Liabilities. 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, with early adoption permitted provided the entity also elects to apply the provisions of Statement No. 157. We do not expect the adoption of Statement No. 159 to have any material impact on our financial position or results of operations.

3. DISPOSITION OF LIMA REFINERY

On May 2, 2007, we entered into an agreement to sell our refinery in Lima, Ohio to Husky Refining Company (Husky), a wholly owned subsidiary of Husky Energy Inc. In addition, our marketing and supply subsidiary separately agreed to sell certain inventory amounts to Husky as part of this transaction. As a result, the assets and liabilities related to these transactions are presented as assets held for sale and liabilities related to assets held for sale, respectively, in the consolidated balance sheet as of December 31, 2006. In addition, the consolidated statements of income reflect the operations related to the Lima Refinery for the periods prior to the effective date of the sale in income from discontinued operations, net of income tax expense.

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

On July 3, 2007, we consummated the sale of our Lima Refinery to Husky with an effective date of July 1, 2007. Proceeds from the sale were approximately $2.4 billion, including approximately $550 million from the sale of working capital to Husky primarily related to the sale of inventory by our marketing and supply subsidiary. The sale resulted in a pre-tax gain of $827 million, or $426 million after tax, which is presented in income from discontinued operations, net of income tax expense in the consolidated statements of income for the three months and nine months ended September 30, 2007. In connection with the sale, we entered into a transition services agreement with Husky under which we agreed to provide certain accounting and administrative services to Husky beginning July 3, 2007, with the services terminating by July 31, 2008.

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

	July 1, 2007	December 31, 2006
Current assets (primarily inventory)	$ 570	$ 456
Property, plant and equipment, net	929	918
Goodwill	107	108
Deferred charges and other assets, net	46	45
Assets held for sale	$1,652	$ 1,527
Current liabilities, including current portion of capital lease obligation	$ 15	$ 29
Capital lease obligation, excluding current portion	38	38
Liabilities related to assets held for sale	$ 53	$ 67

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Operating revenues	$	$ 1,060	$ 2,231	$ 3,181
Income before income tax expense		72	391	235

4. INVENTORIES

Inventories consisted of the following (in millions):

	September 30, 2007	December 31, 2006
Refinery feedstocks	$ 2,123	$ 1,680
Refined products and blendstocks	2,245	2,056
Convenience store merchandise	80	85
Materials and supplies	168	158
Inventories	$ 4,616	$ 3,979

As of September 30, 2007 and December 31, 2006, the replacement cost (market value) of LIFO inventories exceeded their LIFO carrying amounts by approximately $5.2 billion and $2.9 billion, respectively.

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

5. INVESTMENT IN AND TRANSACTIONS WITH NUSTAR ENERGY L.P.

Our ownership interest in NuStar Energy L.P. as of June 30, 2006 was 23.4%, which was composed of a 2% general partner interest, incentive distribution rights, and a 21.4% limited partner interest. The limited partner interest was represented by 10,222,630 common units of NuStar Energy L.P., of which 9,599,322 were previously subordinated units that converted to common units on May 8, 2006 upon the termination of the subordination period in accordance with the terms of NuStar Energy L.P. s partnership agreement.

Through the date of termination of the subordination period, NuStar Energy L.P. had issued common units to the public on three separate occasions, which had diluted our ownership percentage. These three issuances resulted in increases (or credits, known as SAB 51 credits due to the Securities and Exchange Commission Staff Accounting Bulletin that provides accounting guidance for such credits) in our proportionate share of NuStar Energy L.P. s capital because, in each case, the issuance price per unit exceeded our carrying amount per unit at the time of issuance. We had not recognized any SAB 51 credits in our consolidated financial statements through March 31, 2006 and were not permitted to do so until the subordinated units converted to common units. In conjunction with the conversion of the subordinated units held by us to common units in the second quarter of 2006, we recognized the entire balance of $158 million in SAB 51 credits as an increase in our investment in NuStar Energy L.P. and $101 million after tax as an increase to additional paid-in capital in our consolidated balance sheet.

NuStar GP Holdings, LLC completed public offerings in July and December 2006 through which we sold all of our ownership interest in NuStar GP Holdings, LLC. As a result, we no longer owned any interest in NuStar Energy L.P. as of December 31, 2006. Financial information reported by NuStar Energy L.P. for the three months and nine months ended September 30, 2006 is summarized below (in millions):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Revenues	$ 291	$ 845
Operating income	55	158
Net income	41	112

Related-Party Transactions

Through December 31, 2006, we provided NuStar Energy L.P. with certain corporate functions for an annual fee as prescribed by a services agreement. Effective January 1, 2007, the services agreement was amended to provide for limited services. The amended services agreement provided for a termination date of December 31, 2010, unless we terminated the agreement earlier, in which case we were required to pay a termination fee of $13 million. In April, we notified NuStar Energy L.P. of our decision to terminate the services agreement. Accordingly, the $13 million termination fee was accrued and paid during the second quarter of 2007.

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

The following table summarizes the results of transactions with NuStar Energy L.P. for the three months and nine months ended September 30, 2006 (in millions):

	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2006
Fees and expenses charged by us to NuStar Energy L.P.	$ 32	$ 89
Fees and expenses charged to us by NuStar Energy L.P.	69	194

6. DEBT

On February 1, 2007, we redeemed our 9.25% senior notes for $183 million, or 104.625% of stated value. These notes had a carrying amount of $187 million on the date of redemption, resulting in a gain of $4 million that was included in other income, net in the consolidated statement of income.

In April 2007, we repaid in full, at the scheduled maturity date, $230 million related to our 6.125% notes. Also in April 2007, we borrowed $3 billion under a 364-day term credit agreement with a financial institution to fund the accelerated share repurchase program discussed in Note 7. The term loan bore interest at LIBOR plus a margin, or an alternate base rate as defined under the term credit agreement. In May 2007, we repaid $500 million of the borrowings under the term credit agreement. The remaining balance of $2.5 billion was repaid in June 2007 using available cash and proceeds from our issuance of long-term notes described below.

On June 8, 2007, we issued $750 million of 6.125% notes due June 15, 2017 and $1.5 billion of 6.625% notes due June 15, 2037. Proceeds from the issuance of these notes totaled $2.25 billion, before deducting underwriting discounts of $18 million.

During the nine months ended September 30, 2007, we had no borrowings under our revolving credit facilities or our short-term uncommitted bank credit facilities.

7. STOCKHOLDERS EQUITY

Treasury Stock

During the nine months ended September 30, 2007 and 2006, we purchased 68.9 million and 30.8 million shares of our common stock at a cost of $4.8 billion and $1.8 billion, respectively. These purchases were made in connection with the administration of our employee benefit plans and the $6 billion common stock purchase program authorized by our board of directors, including the effect of the accelerated share repurchase program discussed below. During the nine months ended September 30, 2007, we issued 12.4 million shares from treasury at an average cost of $61.65 per share, and for the nine months ended September 30, 2006, we issued 13.2 million shares from treasury at an average cost of $55.29 per share, for our employee benefit plans.

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

Accelerated Share Repurchase Program

On April 25, 2007, our board of directors approved an amendment to our $2 billion common stock purchase program to increase the authorized purchases under the program to $6 billion. In conjunction with the increase in our common stock purchase program, we entered into an agreement with a financial institution to purchase $3 billion of our shares under an accelerated share repurchase program, and in late April 2007, 42.1 million shares were purchased under this agreement. As described in Note 6 above, the purchase of these shares was initially funded with a 364-day term credit agreement, which we subsequently replaced with longer-term financing. The cost of the shares purchased under this accelerated share repurchase program was to be adjusted at the expiration of the program, with the final purchase cost based on a discount to the average trading price of our common stock, weighted by the daily volume of shares traded, during the program period. Any adjustment to the cost could be paid in cash or stock, at our option.

The accelerated share repurchase program was completed on July 23, 2007, resulting in an additional $94 million payment by us for the shares purchased. At that time, we elected to pay this additional amount in cash. This additional cash payment was deducted from reported net income in calculating earnings per common share from continuing operations assuming dilution for the three months and nine months ended September 30, 2007.

Common Stock Dividends

On October 25, 2007, our board of directors declared a regular quarterly cash dividend of $0.12 per common share payable on December 12, 2007 to holders of record at the close of business on November 7, 2007.

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

8. EARNINGS PER COMMON SHARE

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	2006	2007	2006
Earnings per common share from continuing operations:				
Income from continuing operations	$ 848	$ 1,559	$ 3,998	$ 4,206
Less: Preferred stock dividends	-	-	-	2
Income from continuing operations applicable to common stock	$ 848	$ 1,559	$ 3,998	$ 4,204
Weighted-average common shares outstanding	551	609	571	613
Earnings per common share from continuing operations	$ 1.54	$ 2.56	$ 7.00	$ 6.85
Earnings per common share from continuing operations assuming dilution:				
Income from continuing operations	$ 848	$ 1,559	$ 3,998	$ 4,206
Less: Cash paid in final settlement of accelerated share repurchase program	94	-	94	-
Income from continuing operations assuming dilution	$ 754	$ 1,559	$ 3,904	$ 4,206
Weighted-average common shares outstanding	551	609	571	613
Effect of dilutive securities:				
Stock options	11	17	14	19
Performance awards and other benefit plans	1	1	1	1
Mandatory convertible preferred stock and other	1	1	1	3
Weighted-average common shares outstanding assuming dilution	564	628	587	636
Earnings per common share from continuing operations assuming dilution	$ 1.34	$ 2.48	$ 6.66	$ 6.61

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):

	Nine Months Ended September 30,	
	2007	2006
Decrease (increase) in current assets:		
Restricted cash	$	$ (1)
Receivables, net	(1,999)	(20)
Inventories	(695)	(624)
Income taxes receivable	32	3
Prepaid expenses and other	(88)	(113)
Increase (decrease) in current liabilities:		
Accounts payable	1,310	597
Accrued expenses	90	(20)
Taxes other than income taxes	(4)	(49)
Income taxes payable	474	98
Changes in current assets and current liabilities	$ (880)	$ (129)

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

- the amounts shown above exclude changes in cash and temporary cash investments, deferred income taxes, and current portion of long-term debt and capital lease obligations, as well as the effect of certain noncash investing and financing activities discussed below;
- previously accrued capital expenditures, deferred turnaround and catalyst costs, and contingent earn-out payments are reflected in investing activities in the consolidated statements of cash flows;
- changes in assets held for sale and liabilities related to assets held for sale prior to the sale of the Lima Refinery are reflected in the line item to which the changes relate in the table above; and
- certain differences between consolidated balance sheet changes and consolidated statement of cash flow changes reflected above result from translating foreign currency denominated amounts at different exchange rates.

There were no significant noncash investing or financing activities for the nine months ended September 30, 2007. Noncash investing activities for the nine months ended September 30, 2006 included the pre-tax recognition of $158 million of SAB 51 credits related to our investment in NuStar Energy L.P. (as discussed in Note 5). Noncash investing activities also included adjustments to property, plant and equipment, goodwill, and certain current and noncurrent assets and liabilities resulting from adjustments to the purchase price allocation related to the acquisitions of Premcor Inc. (Premcor) and Ultramar Diamond Shamrock Corporation. Noncash financing activities for the nine months ended September 30, 2006 included the conversion of 3,164,151 shares of preferred stock into 6,271,327 shares of our common stock and the recognition of a $39 million capital lease obligation and related capital lease asset pertaining to certain facilities at the Lima Refinery.

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

Cash flows related to the discontinued operations of the Lima Refinery have been combined with the cash flows from continuing operations within each category in the consolidated statement of cash flows for each period presented. Cash provided by operating activities related to our discontinued results of operations was $260 million and $170 million for the nine months ended September 30, 2007 and 2006, respectively. Cash used in investing activities related to the Lima Refinery was $14 million and $117 million for the nine months ended September 30, 2007 and 2006, respectively.

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

	Nine Months Ended September 30,	
	2007	**2006**
Interest paid (net of amount capitalized)	$ 152	$ 165
Income taxes paid (net of tax refunds received)	1,813	1,759

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 September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Fair value hedges	$ 3	$ (2)	$ 1	$ (8)
Cash flow hedges	(17)	2	(23)	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 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 nine months ended September 30, 2007, we recognized in accumulated other comprehensive income unrealized after-tax losses of $18 million on certain cash flow hedges, primarily related to forward sales of distillates and associated forward purchases of crude oil, with $17 million of cumulative after-tax gains on cash flow hedges remaining in accumulated other comprehensive income as of September 30, 2007. We expect that the deferred gains as of September 30, 2007 will be reclassified into cost of sales over the next nine months as a result of hedged transactions that are forecasted to occur. The amount ultimately realized in income, however, will differ as commodity prices change. For the nine months ended September 30, 2007 and 2006, there were no amounts reclassified from accumulated other comprehensive income into income as a result of the discontinuance of cash flow hedge accounting.

11. INCOME TAXES

As discussed in Note 2, on January 1, 2007, we adopted the provisions of FIN 48. We did not recognize a significant change in our liability for uncertain tax positions as a result of our implementation of FIN 48;

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

however, certain amounts previously reported in deferred income taxes were reclassified to other long-term liabilities in the consolidated balance sheet as of January 1, 2007. In accordance with the provisions of FIN 48, prior period amounts were not reclassified. The total amount of unrecognized tax benefits as of January 1, 2007 was $179 million of which $85 million, if recognized, would impact our effective rate. Accrued liabilities for interest and penalties related to unrecognized tax benefits were $43 million as of January 1, 2007. We anticipate that any matters resolved with tax authorities within the next 12 months will not result in a material change in our financial position or results of operations. As of September 30, 2007, we remain subject to examination in the U.S. federal and various state jurisdictions for the tax years from 1999 through 2006 and Canadian federal and various provincial jurisdictions for tax years from 2001 to 2006.

12. SEGMENT INFORMATION

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

	Refining	Retail	Corporate	Total
Three months ended September 30, 2007:				
Operating revenues from external customers	$21,399	$2,300	$ -	$23,699
Intersegment revenues	1,610	-	-	1,610
Operating income (loss)	1,259	74	(165)	1,168
Three months ended September 30, 2006:				
Operating revenues from external customers	20,995	2,243	-	23,238
Intersegment revenues	1,547	-	-	1,547
Operating income (loss)	2,313	96	(148)	2,261
Nine months ended September 30, 2007:				
Operating revenues from external customers	60,131	6,525	-	66,656
Intersegment revenues	4,573	-	-	4,573
Operating income (loss)	6,362	183	(511)	6,034
Nine months ended September 30, 2006:				
Operating revenues from external customers	62,440	6,365	-	68,805
Intersegment revenues	4,459	-	-	4,459
Operating income (loss)	6,624	163	(489)	6,298

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

	September 30, 2007	December 31, 2006
Refining	$ 36,302	$ 34,275
Retail	1,980	1,826
Corporate	3,579	1,652
Total consolidated assets	$ 41,861	$ 37,753

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

The entire balance of goodwill as of September 30, 2007 and December 31, 2006 has been included in the total assets of the refining reportable segment. Assets held for sale related to the Lima Refinery were included in the refining reportable segment as of December 31, 2006.

13. EMPLOYEE BENEFIT PLANS

The components of net periodic benefit cost related to our defined benefit plans were as follows for the three months and nine months ended September 30, 2007 and 2006 (in millions):

	Pension Plans		Other Postretirement Benefit Plans	
	2007	2006	2007	2006
Three months ended September 30:				
Components of net periodic benefit cost:				
Service cost	$ 23	$ 23	$ 3	$ 3
Interest cost	18	16	7	6
Expected return on plan assets	(21)	(14)	-	-
Amortization of:				
Prior service cost (credit)	1	1	(2)	(2)
Net loss	2	3	2	2
Net periodic benefit cost before special charges	23	29	10	9
Charge for special termination benefits	5	-	-	-
Net periodic benefit cost	$ 28	$ 29	$10	$ 9
Nine months ended September 30:				
Components of net periodic benefit cost:				
Service cost	$ 71	$ 73	$10	$10
Interest cost	53	48	20	18
Expected return on plan assets	(63)	(43)	-	-
Amortization of:				
Prior service cost (credit)	2	2	(7)	(7)
Net loss	7	10	5	5
Net periodic benefit cost before special charges	70	90	28	26
Charge for special termination benefits	12	-	1	-
Net periodic benefit cost	$ 82	$ 90	$29	$26

Although we had only $1 million of minimum required contributions to our qualified pension plans during 2007 under the Employee Retirement Income Security Act, we contributed $43 million to our qualified plans during the nine months ended September 30, 2007. For the nine months ended September 30, 2006, we contributed $143 million to our qualified pension plans.

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

14. COMMITMENTS AND CONTINGENCIES

Accounts Receivable Sales Facility

As of September 30, 2007, we had an accounts receivable sales facility with a group of third-party financial institutions to sell on a revolving basis up to $1 billion of eligible trade receivables, which matures in August 2008. During the third quarter of 2007, we reduced the amount of eligible receivables sold to the third-party financial institutions by $900 million. As a result, as of September 30, 2007 and December 31, 2006, the amount of eligible receivables sold to the third-party financial institutions was $100 million and $1 billion, respectively.

Contingent Earn-Out Agreements

In both June 2007 and July 2006, we made previously accrued payments of $25 million related to the Delaware City Refinery contingent earn-out agreement. The 2007 payment represented the final payment under that agreement. In both January 2007 and January 2006, we made previously accrued earn-out payments of $50 million related to the acquisition of the St. Charles Refinery. In the second quarter of 2006, we made a final earn-out contingency payment of $26 million to Salomon Inc in conjunction with our acquisition of Basis Petroleum, Inc.

The following table summarizes the aggregate payments we have made through September 30, 2007 and payment limitations related to the following acquisitions (in millions):

	Aggregate Payments Made Through September 30, 2007	Annual Maximum Limit	Aggregate Limit
St. Charles Refinery	$ 150	$ 50	$ 175
Delaware City Refinery	50	25	50

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. Certain 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. No amounts have been accrued on exports with respect to this turnover tax. We have commenced arbitration proceedings with the Netherlands Arbitration Institute pursuant to which we will seek to enforce our rights under the tax holiday.

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

Litigation

MTBE Litigation

As of November 1, 2007, we were named as a defendant in 82 active 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. Although most of the cases are pending in federal court and 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 recent ruling on jurisdiction from the U.S. Court of Appeals for the Second Circuit may result in a remand of many of the cases to state court. Three cases, *State of New Hampshire, Riverview Water District,* and *California Water Services Company*, have already been remanded to state courts in New Hampshire and California. We are involved in four cases that have been selected as focus cases for discovery and pre-trial motions. One of these, the *Suffolk County Water Authority* case, is scheduled for trial in March 2008. Activity in the non-focus cases is generally stayed. We believe that we have strong defenses to these claims and are vigorously defending the cases. We have recorded a loss contingency liability with respect to this matter in accordance with FASB Statement No. 5. However, due to the inherent uncertainty of litigation, we believe that it is reasonably possible (as defined in FASB Statement No. 5) that we may suffer a loss with respect to one or more of the lawsuits in excess of the amount accrued. We believe that such an outcome in any one of these lawsuits would not have a material adverse effect on our results of operations or financial position. However, we believe that an adverse result in all or a substantial number of these cases could have a material effect on our results of operations and financial position. An estimate of the possible loss or range of loss from an adverse result in all or substantially all of these cases cannot reasonably be made.

Retail Fuel Temperature Litigation

Along with several other defendants in the retail petroleum marketing business, as of November 1, 2007, we were named in 22 consumer class action lawsuits relating to fuel temperature. 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 multidistrict 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*). We believe that we have several strong defenses to these lawsuits and intend to contest them. We have not recorded a loss contingency liability with respect to this matter, but due to the inherent uncertainty of litigation, we believe that it is reasonably possible (as defined in FASB Statement No. 5) that we may suffer a loss with respect to one or more of the lawsuits. An estimate of the possible loss or range of loss from an adverse result in all or substantially all of these cases cannot reasonably be made.

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

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.

15. CONDENSED CONSOLIDATING FINANCIAL INFORMATION

In conjunction with the acquisition of Premcor 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 September 30, 2007:

- 6.75% senior notes due February 2011,
- 6.125% senior notes due May 2011,
- 9.5% senior notes due February 2013,
- 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 September 30, 2007
(unaudited, in millions)

	Valero Energy Corporation	PRG	Other Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Current assets:					
Cash and temporary cash investments	$ 2,262	$ -	$ 847	$ -	$ 3,109
Restricted cash	23	2	6	-	31
Receivables, net	1	72	6,390	-	6,463
Inventories	-	390	4,226	-	4,616
Income taxes receivable	-	-	1	(1)	-
Deferred income taxes	-	-	197	-	197
Prepaid expenses and other	-	7	231	-	238
Total current assets	2,286	471	11,898	(1)	14,654
Property, plant and equipment, at cost	-	6,607	18,470	-	25,077
Accumulated depreciation	-	(366)	(3,487)	-	(3,853)
Property, plant and equipment, net	-	6,241	14,983	-	21,224
Intangible assets, net	-	2	296	-	298
Goodwill	-	1,819	2,242	-	4,061
Investment in Valero Energy affiliates	7,636	1,006	1,288	(9,930)	-
Long-term notes receivable from affiliates	16,708	-	-	(16,708)	-
Deferred charges and other assets, net	215	369	1,240	(200)	1,624
Total assets	$26,845	$9,908	$31,947	$(26,839)	$41,861
LIABILITIES AND STOCKHOLDERS EQUITY					
Current liabilities:					
Current portion of long-term debt and capital lease obligations	$ 57	$ -	$ 3	$ -	$ 60
Accounts payable	68	220	7,857	-	8,145
Accrued expenses	164	51	393	-	608
Taxes other than income taxes	-	23	589	-	612
Income taxes payable	407	88	-	(1)	494
Deferred income taxes	51	272	-	-	323
Total current liabilities	747	654	8,842	(1)	10,242

Long-term debt and capital lease obligations, less current portion	5,526	1,287	41	-	6,854
Long-term notes payable to affiliates	-	6,489	10,219	(16,708)	-
Deferred income taxes	806	-	3,335	(200)	3,941
Other long-term liabilities	798	190	868	-	1,856
Stockholders equity:					
Common stock	6	-	2	(2)	6
Additional paid-in capital	7,366	100	3,395	(3,495)	7,366
Treasury stock	(5,308)	-	-	-	(5,308)
Retained earnings	16,413	1,187	5,238	(6,425)	16,413
Accumulated other comprehensive income	491	1	7	(8)	491
Total stockholders equity	18,968	1,288	8,642	(9,930)	18,968
Total liabilities and stockholders equity	$26,845	$9,908	$31,947	$(26,839)	$41,861

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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
Condensed Consolidating Balance Sheet as of December 31, 2006
(in millions)

	Valero Energy Corporation	PRG	Other Non-Guarantor Subsidiaries	Eliminations	Consolidated
ASSETS					
Current assets:					
Cash and temporary cash investments	$ 712	$ -	$ 878	$ -	$ 1,590
Restricted cash	22	2	7	-	31
Receivables, net	1	76	4,307	-	4,384
Inventories	-	377	3,602	-	3,979
Income taxes receivable	-	5	32	(5)	32
Deferred income taxes	-	-	143	-	143
Prepaid expenses and other	-	12	133	-	145
Assets held for sale	-	977	550	-	1,527
Total current assets	735	1,449	9,652	(5)	11,831
Property, plant and equipment, at cost	-	6,481	16,940	-	23,421
Accumulated depreciation	-	(231)	(3,010)	-	(3,241)
Property, plant and equipment, net	-	6,250	13,930	-	20,180
Intangible assets, net	-	3	300	-	303
Goodwill	-	1,826	2,277	-	4,103
Investment in Valero Energy affiliates	2,114	705	101	(2,920)	-
Long-term notes receivable from affiliates	20,920	-	-	(20,920)	-
Deferred income taxes	-	111	-	(111)	-
Deferred charges and other assets, net	196	184	956	-	1,336
Total assets	$23,965	$10,528	$27,216	$(23,956)	$37,753
LIABILITIES AND STOCKHOLDERS EQUITY					
Current liabilities:					
Current portion of long-term debt and capital lease obligations	$ 285	$ 187	$ 3	$ -	$ 475
Accounts payable	80	281	6,480	-	6,841
Accrued expenses	76	76	355	-	507
Taxes other than income taxes	-	19	565	-	584
Income taxes payable	21	-	7	(5)	23
Deferred income taxes	91	272	-	-	363
Liabilities related to assets held for sale	-	67	-	-	67

Total current liabilities	553	902	7,410	(5)	8,860
Long-term debt and capital lease obligations, less current portion	3,281	1,295	43	-	4,619
Long-term notes payable to affiliates	-	8,003	12,917	(20,920)	-
Deferred income taxes	868	-	3,290	(111)	4,047
Other long-term liabilities	658	227	737	-	1,622
Stockholders equity:					
Common stock	6	-	2	(2)	6
Additional paid-in capital	7,779	100	1,458	(1,558)	7,779
Treasury stock	(1,396)	-	-	-	(1,396)
Retained earnings	11,951	-	1,322	(1,322)	11,951
Accumulated other comprehensive income	265	1	37	(38)	265
Total stockholders equity	18,605	101	2,819	(2,920)	18,605
Total liabilities and stockholders equity	$23,965	$10,528	$27,216	$(23,956)	$37,753

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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 September 30, 2007
(unaudited, in millions)

	Valero Energy Corporation	PRG	Other Non-Guarantor Subsidiaries	Eliminations	Consolidated
Operating revenues	$ -	$6,008	$24,546	$(6,855)	$23,699
Costs and expenses:					
Cost of sales	-	5,654	22,011	(6,855)	20,810
Refining operating expenses	-	236	800	-	1,036
Retail selling expenses	-	-	190	-	190
General and administrative expenses	(6)	20	138	-	152
Depreciation and amortization expense	-	77	266	-	343
Total costs and expenses	(6)	5,987	23,405	(6,855)	22,531
Operating income	6	21	1,141	-	1,168
Equity in earnings of subsidiaries	1,017	150	487	(1,654)	-
Other income (expense), net	432	(20)	193	(460)	145
Interest and debt expense:					
Incurred	(153)	(137)	(318)	460	(148)
Capitalized	-	2	23	-	25
Income from continuing operations before income tax expense (benefit)	1,302	16	1,526	(1,654)	1,190
Income tax expense (benefit) (1)	28	(45)	359	-	342
Income from continuing operations	1,274	61	1,167	(1,654)	848
Income from discontinued operations, net of income tax expense	-	426	-	-	426
Net income	$1,274	$ 487	$ 1,167	$(1,654)	$ 1,274

(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 September 30, 2006
(unaudited, in millions)

	Valero Energy Corporation	PRG	Other Non-Guarantor Subsidiaries	Eliminations	Consolidated
Operating revenues	$ -	$6,335	$22,834	$(5,931)	$23,238
Costs and expenses:					
Cost of sales	-	6,046	19,367	(5,931)	19,482
Refining operating expenses	-	182	707	-	889
Retail selling expenses	-	-	185	-	185
General and administrative expenses	-	-	136	-	136
Depreciation and amortization expense	-	59	226	-	285
Total costs and expenses	-	6,287	20,621	(5,931)	20,977
Operating income	-	48	2,213	-	2,261
Equity in earnings of subsidiaries	1,429	353	294	(2,076)	-
Equity in earnings of NuStar Energy L.P.	-	-	13	-	13
Other income (expense), net	320	(82)	365	(460)	143
Interest and debt expense:					
Incurred	(101)	(152)	(298)	460	(91)
Capitalized	-	18	27	-	45
Minority interest in net income of consolidated subsidiary	-	-	(4)	-	(4)
Income from continuing operations before income tax expense (benefit)	1,648	185	2,610	(2,076)	2,367
Income tax expense (benefit) (1)	45	(65)	828	-	808
Income from continuing operations	1,603	250	1,782	(2,076)	1,559
Income from discontinued operations, net of income tax expense	-	44	-	-	44
Net income	$1,603	$ 294	$ 1,782	$(2,076)	$ 1,603

(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 Nine Months Ended September 30, 2007
(unaudited, in millions)

	Valero Energy Corporation	PRG	Other Non-Guarantor Subsidiaries	Eliminations	Consolidated
Operating revenues	$ -	$16,960	$65,812	$(16,116)	$66,656
Costs and expenses:					
Cost of sales	-	15,051	56,695	(16,116)	55,630
Refining operating expenses	-	644	2,311	-	2,955
Retail selling expenses	-	-	561	-	561
General and administrative expenses	(6)	27	453	-	474
Depreciation and amortization expense	-	227	775	-	1,002
Total costs and expenses	(6)	15,949	60,795	(16,116)	60,622
Operating income	6	1,011	5,017	-	6,034
Equity in earnings of subsidiaries	4,039	492	1,190	(5,721)	-
Other income (expense), net	1,131	(151)	629	(1,452)	157
Interest and debt expense:					
Incurred	(367)	(442)	(990)	1,452	(347)
Capitalized	-	4	79	-	83
Income from continuing operations before income tax expense	4,809	914	5,925	(5,721)	5,927
Income tax expense (1)	142	214	1,573	-	1,929
Income from continuing operations	4,667	700	4,352	(5,721)	3,998
Income from discontinued operations, net of income tax expense	-	490	179	-	669
Net income	$4,667	$ 1,190	$ 4,531	$ (5,721)	$ 4,667

(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 Nine Months Ended September 30, 2006
(unaudited, in millions)

	Valero Energy Corporation	PRG	Other Non-Guarantor Subsidiaries	Eliminations	Consolidated
Operating revenues	$ -	$ 18,220	$ 67,859	$ (17,274)	$ 68,805
Costs and expenses:					
Cost of sales	-	16,987	58,294	(17,274)	58,007
Refining operating expenses	-	558	2,126	-	2,684
Retail selling expenses	-	-	539	-	539
General and administrative expenses	2	26	430	-	458
Depreciation and amortization expense	-	187	632	-	819
Total costs and expenses	2	17,758	62,021	(17,274)	62,507
Operating income (loss)	(2)	462	5,838	-	6,298
Equity in earnings of subsidiaries	3,899	681	782	(5,362)	-
Equity in earnings of NuStar Energy L.P.	-	-	35	-	35
Other income (expense), net	1,041	(86)	943	(1,760)	138
Interest and debt expense:					
Incurred	(379)	(548)	(1,113)	1,760	(280)
Capitalized	-	46	80	-	126
Minority interest in net income of consolidated subsidiary	-	-	(4)	-	(4)
Income from continuing operations before income tax expense (benefit)	4,559	555	6,561	(5,362)	6,313
Income tax expense (benefit) (1)	210	(84)	1,981	-	2,107
Income from continuing operations	4,349	639	4,580	(5,362)	4,206
Income from discontinued operations, net of income tax expense	-	143	-	-	143
Net income	4,349	782	4,580	(5,362)	4,349
Preferred stock dividends	2	-	-	-	2
Net income applicable to common stock	$ 4,347	$ 782	$ 4,580	$ (5,362)	$ 4,347

(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 Cash Flows for the Nine Months Ended September 30, 2007
(unaudited, in millions)

	Valero Energy Corporation	PRG (1)	Other Non-Guarantor Subsidiaries (1)	Eliminations	Consolidated
Net cash provided by operating activities	$ 1,049	$ 69	$ 2,888	$ -	$ 4,006
Cash flows from investing activities:					
Capital expenditures	-	(218)	(1,335)	-	(1,553)
Deferred turnaround and catalyst costs	-	(44)	(294)	-	(338)
Investment in Cameron Highway Oil Pipeline Company, net	-	-	(212)	-	(212)
Proceeds from sale of Lima Refinery	-	1,873	555	-	2,428
Contingent payments in connection with acquisitions	-	(25)	(50)	-	(75)
Investments in subsidiaries	(2,742)	(58)	-	2,800	-
Return of investment	1,305	-	3	(1,308)	-
Net intercompany loan repayments	4,538	-	-	(4,538)	-
Other investing activities, net	-	4	14	-	18
Net cash provided by (used in) investing activities	3,101	1,532	(1,319)	(3,046)	268
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 treasury stock	(4,751)	-	-	-	(4,751)
Benefit from tax deduction in excess of recognized stock-based compensation cost	231	-	-	-	231
Dividends to parent	-	(3)	(1,305)	1,308	-
Capital contributions from parent	-	-	2,800	(2,800)	-
Net intercompany loan repayments	-	(1,415)	(3,123)	4,538	-
Other financing activities, net	(95)	-	(3)	-	(98)

Net cash used in financing activities	(2,600)	(1,601)	(1,631)	3,046	(2,786)
Effect of foreign exchange rate changes on cash	-	-	31	-	31
Net increase (decrease) in cash and temporary cash investments	1,550	-	(31)	-	1,519
Cash and temporary cash investments at beginning of period	712	-	878	-	1,590
Cash and temporary cash investments at end of period	$ 2,262	$ -	$ 847	$ -	$ 3,109

(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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VALERO ENERGY CORPORATION AND SUBSIDIARIES
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)
Condensed Consolidating Statement of Cash Flows for the Nine Months Ended September 30, 2006
(unaudited, in millions)

	Valero Energy Corporation	PRG	Other Non-Guarantor Subsidiaries	Eliminations	Consolidated
Net cash provided by operating activities	$ 823	$ 349	$ 3,924	$ -	$ 5,096
Cash flows from investing activities:					
Capital expenditures	-	(796)	(1,535)	-	(2,331)
Deferred turnaround and catalyst costs	-	(146)	(318)	-	(464)
Contingent payments in connection with acquisitions	-	(25)	(76)	-	(101)
Proceeds from sale of interest in NuStar GP Holdings, LLC	-	-	355	-	355
Net intercompany loan repayments	1,755	-	-	(1,755)	-
Other investing activities, net	-	(3)	32	-	29
Net cash provided by (used in) investing activities	1,755	(970)	(1,542)	(1,755)	(2,512)
Cash flows from financing activities:					
Long-term note repayments	(221)	(28)	-	-	(249)
Bank credit agreements:					
Borrowings	8	-	699	-	707
Repayments	(8)	-	(698)	-	(706)
Termination of interest rate swaps	(54)	-	-	-	(54)
Purchase of treasury stock	(1,818)	-	-	-	(1,818)
Benefit from tax deduction in excess of recognized stock-based compensation cost	160	-	-	-	160
Net intercompany borrowings (repayments)	-	644	(2,399)	1,755	-
Other financing activities, net	(35)	-	(2)	-	(37)
Net cash provided by (used in) financing activities	(1,968)	616	(2,400)	1,755	(1,997)
Effect of foreign exchange rate changes on cash	-	-	6	-	6

Net increase (decrease) in cash and temporary cash investments	610	(5)	(12)	-	593
Cash and temporary cash investments at beginning of period	11	5	420	-	436
Cash and temporary cash investments at end of period	$ 621	$ -	$ 408	$ -	$ 1,029

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

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

- acts of terrorism aimed at either our facilities or other facilities that could impair our ability to produce or transport refined products or receive feedstocks;
- political and economic conditions in nations that consume refined products, including the United States, and in crude oil producing regions, including the Middle East and South America;
- the domestic and foreign supplies of refined products such as gasoline, diesel fuel, jet fuel, home heating oil, and petrochemicals;
- the domestic and foreign supplies of crude oil and other feedstocks;
- the ability of the members of the Organization of Petroleum Exporting Countries (OPEC) to agree on and to maintain crude oil price and production controls;
- the level of consumer demand, including seasonal fluctuations;

refinery overcapacity or undercapacity;

the actions taken by competitors, including both pricing and the expansion and retirement of refining capacity in response to market conditions;

environmental, tax, and other regulations at the municipal, state, and federal levels and in foreign countries;

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

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

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

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OVERVIEW

In this overview, we describe some of the primary factors that we believe affected our operations in the third quarter and first nine months of 2007. 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. Gasoline and distillate margins in the third quarter of 2007 were comparable to such margins in the third quarter of 2006 in all regions other than the West Coast region where such margins were significantly weaker. Compared to the second quarter of 2007, gasoline margins were significantly lower in the third quarter of 2007 due to the seasonal transition to lower gasoline demand and less restrictive gasoline specifications.

Since approximately 65% of our total crude oil throughput represents sour crude oil and acidic sweet crude oil feedstocks that are purchased at prices less than sweet crude oil, our profitability is also significantly affected by the spread between sweet crude oil and sour crude oil prices, referred to as the sour crude oil differential. Sour crude oil differentials relative to WTI crude oil for the third quarter of 2007 improved somewhat compared to second quarter 2007 levels but were significantly lower than the strong differentials in the third quarter of 2006. However, the sour crude oil differentials relative to light, sweet crude oils other than WTI in the third quarter of 2007 were comparable to those experienced in the third quarter of 2006.

On February 16, 2007, our McKee Refinery was shut down due to a fire originating in its propane deasphalting unit, which reduced operating income by approximately $325 million in the first nine months of 2007. The refinery recommenced operations on April 12 at a reduced throughput rate, with run rates by the end of September having increased to near full capacity. During the third quarter of 2007, operating results were unfavorably affected by the impact of Hurricane Humberto on the Port Arthur Refinery s operations as well as operational issues at the Port Arthur, Aruba, and Ardmore Refineries.

Effective July 1, 2007, we consummated the sale of our refinery in Lima, Ohio to Husky Refining Company (Husky), a wholly owned subsidiary of Husky Energy Inc. The sales price was approximately $2.4 billion, including approximately $550 million from the sale of working capital to Husky primarily related to the sale of inventory by our marketing and supply subsidiary. The sale resulted in a pre-tax gain of $827 million. During the third quarter of 2007, we also recognized a pre-tax gain of $91 million related to a foreign currency exchange rate gain resulting from the repayment of a loan by a foreign subsidiary, and we made a $94 million cash payment in final settlement of an accelerated share repurchase program entered into in the second quarter of 2007 under which we purchased 42.1 million shares of our common stock.

We reported income from continuing operations of $848 million, or $1.34 per share, for the third quarter of 2007 compared to $1.6 billion, or $2.48 per share, for the third quarter of 2006. Income from continuing operations for the first nine months of 2007 was $4.0 billion, or $6.66 per share, compared to $4.2 billion, or $6.61 per share, for the first nine months of 2006. During the first nine months of 2007, we generated $4.0 billion of net cash from operating activities and purchased $4.8 billion of our common stock, including $3.1 billion under the accelerated share repurchase program discussed above.

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RESULTS OF OPERATIONS

Third Quarter 2007 Compared to Third Quarter 2006

Financial Highlights
(millions of dollars, except per share amounts)

	Three Months Ended September 30,		
	2007	**2006 (a)**	**Change**
Operating revenues (b)	$23,699	$23,238	$ 461
Costs and expenses:			
Cost of sales (b)	20,810	19,482	1,328
Refining operating expenses	1,036	889	147
Retail selling expenses (b)	190	185	5
General and administrative expenses	152	136	16
Depreciation and amortization expense:			
Refining	307	252	55
Retail	23	21	2
Corporate	13	12	1
Total costs and expenses	22,531	20,977	1,554
Operating income	1,168	2,261	(1,093)
Equity in earnings of NuStar Energy L.P. (c)	-	13	(13)
Other income, net	145	143	2
Interest and debt expense:			
Incurred	(148)	(91)	(57)
Capitalized	25	45	(20)
Minority interest in net income of consolidated subsidiary (c)	-	(4)	4
Income from continuing operations before income tax expense	1,190	2,367	(1,177)
Income tax expense	342	808	(466)
Income from continuing operations	848	1,559	(711)
Income from discontinued operations, net of income tax expense (a)	426	44	382
Net income	$ 1,274	$ 1,603	$ (329)
Earnings per common share assuming dilution:			
Continuing operations	$ 1.34	$ 2.48	$ (1.14)
Discontinued operations	0.75	0.07	0.68
Total	$ 2.09	$ 2.55	$ (0.46)

See the footnote references on page 36.

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

		Three Months Ended September 30,				
		2007	**2006**		**Change**	
Refining (a):						
Operating income		$1,259	$2,313		$ (1,054)	
Throughput margin per barrel (d)		$ 9.94	$13.17		$ (3.23)	
Operating costs per barrel:						
Refining operating expenses		$ 3.96	$ 3.39		$ 0.57	
Depreciation and amortization	&nD VALIGN="bottom">	56,599	56,574	5/21/2007	25	
Euro		45,525	55,071	60,601	5/22/2007	(5,530)
Euro		25,061	30,246	33,360	5/29/2007	(3,114)
Canadian Dollar	C$	23,000	19,684	19,937	5/29/2007	(253)
Canadian Dollar	C$	22,500	19,189	19,503	6/20/2007	(314)
British Pound	£	6,750	13,265	13,239	6/23/2007	26
			$ 295,209	$ 307,562		($ 12,353)

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APOLLO INVESTMENT CORPORATION

NOTES TO FINANCIAL STATEMENTS (unaudited) (continued)

(in thousands except share and per share amounts)

Note 8. Expense Offset Arrangement

The Company benefits from an expense offset arrangement with JPMorgan Chase Bank, N.A. (custodian bank) whereby the Company earns credits on any uninvested US dollar cash balances held by the custodian bank. These credits are applied by the custodian bank as a reduction of the monthly custody fees charged to the Company. The total amount of credits earned during the three months ended June 30, 2007 and June 30, 2006 is $61 and $12, respectively.

Note 9. Cash Equivalents

Pending investment in longer-term portfolio holdings, Apollo Investment makes temporary investments in U.S. Treasury bills (of varying maturities) and repurchase agreements as outlined in our prospectus. These temporary investments are deemed cash equivalents by us and are included in our Schedule of Investments. At the end of each fiscal quarter, the Company typically takes proactive steps to prospectively preserve investment flexibility in the next quarter which is assessed against the Company s total assets at its most recent quarter end. The Company can accomplish this in many ways including its current practice of purchasing U.S. Treasury bills and closing out its position on a net cash basis subsequent to quarter end. The Company may also utilize repurchase agreements or other balance sheet transactions as it deems appropriate for this purpose and these amounts are excluded from total assets for purposes of computing the asset base upon which the management fee is determined. U.S. Treasury bills with maturities of greater than 60 days from the time of purchase are marked-to-market as per our valuation policy. U.S. Treasury bills settle regular way on trade date plus one.

Note 10. Repurchase Agreements

The Company enters into repurchase agreements as part of its investment program. The Company s custodian takes possession of collateral pledged by the counterparty. The collateral is marked-to-market daily to ensure that the value, plus accrued interest, is at least equal to the repurchase price. In the event of default of the obligor to repurchase, the Company has the right to liquidate the collateral and apply the proceeds in satisfaction of the obligation. Under certain circumstances, in the event of default or bankruptcy by the counterparty to the agreement, realization and/or retention of the collateral or proceeds may be subject to legal proceedings. There were no repurchase agreements outstanding at June 30, 2007 or March 31, 2007.

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APOLLO INVESTMENT CORPORATION

NOTES TO FINANCIAL STATEMENTS (continued)

(in thousands except share and per share amounts)

Note 11. Financial Highlights

The following is a schedule of financial highlights for the three months ended June 30, 2007 and the year ended March 31, 2007:

Per Share Data:	**Three months ended June 30, 2007 (unaudited)**	**Year ended March 31, 2007**
Net asset value, beginning of period	$ 17.87	$ 15.15
Net investment income	0.53	1.49
Net realized and unrealized gain	1.19	2.11
Net increase in net assets resulting from operations	1.72	3.60
Dividends to shareholders (1)	(0.51)	(1.96)
Effect of anti-dilution	0.01	1.09
Offering costs		(0.01)
Net asset value at end of period	$ 19.09	$ 17.87
Per share market value at end of period	$ 21.52	$ 21.40
Total return (2)	2.89%	31.70%
Shares outstanding at end of period	103,900,254	103,507,766
Ratio/Supplemental Data:		
Net assets at end of period (in millions)	$ 1,983.3	$ 1,849.7
Ratio of net investment income to average net assets	2.96%	9.09%
Ratio of operating expenses to average net assets*	1.44%	7.73%
Ratio of credit facility related expenses to average net assets	0.41%	2.49%
Ratio of total expenses to average net assets*	1.85%	10.22%
Average debt outstanding	$ 445,624	$ 580,209
Average debt per share	$ 4.30	$ 6.76
Portfolio turnover ratio	14.0%	43.8%

(1) Dividends and distributions are determined based on taxable income calculated in accordance with income tax regulations which may differ from amounts determined under accounting principles generally accepted in the United States of America.

(2) Total return is based on the change in market price per share during the respective periods. Total return also takes into account dividends and distributions, if any, reinvested in accordance with the Company s dividend reinvestment plan. Total return is not annualized.

* The ratio of operating expenses to average net assets and the ratio of total expenses to average net assets is 1.44% and 1.85%, respectively, at June 30, 2007, inclusive of the expense offset arrangement (see Note 8). At March 31, 2007, the ratios were 7.72% and 10.21%, respectively.

APOLLO INVESTMENT CORPORATION

NOTES TO FINANCIAL STATEMENTS (unaudited) (continued)

(in thousands except share and per share amounts)

Information about our senior securities is shown in the following table as of each year ended March 31 since the Company commenced operations, unless otherwise noted. The indicates information which the SEC expressly does not require to be disclosed for certain types of senior securities.

Class and Year	Total Amount Outstanding (1)	Asset Coverage Per Unit(2)	Involuntary Liquidating Preference Per Unit(3)	Average Market Value Per Unit(4)
Revolving Credit Facility				
Fiscal 2008 (through June 30, 2007)	$ 791,384	$ 3,506	$	N/A
Fiscal 2007	492,312	4,757		N/A
Fiscal 2006	323,852	4,798		N/A
Fiscal 2005	0	0		N/A

(1) Total amount of each class of senior securities outstanding at the end of the period presented (in 000 s).
(2) The asset coverage ratio for a class of senior securities representing indebtedness is calculated as our consolidated total assets, less all liabilities and indebtedness not represented by senior securities, divided by senior securities representing indebtedness. This asset coverage ratio is multiplied by $1,000 to determine the Asset Coverage Per Unit.
(3) The amount to which such class of senior security would be entitled upon the involuntary liquidation of the issuer in preference to any security junior to it.
(4) Not applicable, as senior securities are not registered for public trading.

Note 12. Credit Agreement and Borrowings

Under the terms of the amended and restated Credit Agreement dated March 31, 2006 (the Facility), the lenders agreed to extend credit to Apollo Investment in an aggregate principal or face amount not exceeding $1.25 billion at any one time outstanding. The amended Facility also permits Apollo to seek additional commitments from new and existing lenders in the future, up to an aggregate amount not to exceed $2 billion. In February 2007, we increased total commitments to $1.7 billion. The Facility is a five-year revolving facility (with a stated maturity date of April 14, 2011) and is secured by substantially all of the assets in Apollo Investment s portfolio, including cash and cash equivalents. Pricing is set at 100 basis points over LIBOR. The Facility contains affirmative and restrictive covenants, including: (a) periodic financial reporting requirements, (b) maintaining minimum shareholders equity of the greater of (i) 40% of the total assets of Apollo Investment and its subsidiaries as at the last day of any fiscal quarter and (ii) the sum of (A) $300 million plus (B) 25% of the net proceeds from the sale of equity interests in Apollo Investment after the closing date of the Facility, (c) maintaining a ratio of total assets, less total liabilities (other than indebtedness) to total indebtedness, in each case of Apollo Investment and its subsidiaries, of not less than 2.0:1.0, (d) maintaining minimum liquidity, (e) limitations on the incurrence of additional indebtedness, (f) limitations on liens, (g) limitations on investments (other than in the ordinary course of Apollo Investment s business), (h) limitations on mergers and disposition of assets (other than in the normal course of Apollo Investment s business activities) and (i) limitations on the creation or existence of agreements that permit liens on properties of Apollo Investment s subsidiaries. In addition to the asset coverage ratio described in clause (c) of the preceding sentence, borrowings under the Facility (and the incurrence of certain other permitted debt) are subject to compliance with a borrowing base that applies different advance rates to different types of assets in Apollo Investment s portfolio. The Facility currently provides for the ability of Apollo Investment to seek additional commitments from lenders in an aggregate amount of up to $300 million. The Facility is used to supplement Apollo Investment s equity capital to make additional portfolio investments and for other general corporate purposes.

The average debt outstanding on the credit facility was $445,624 and $418,020 for the three months ended June 30, 2007 and 2006, respectively. The maximum amount borrowed during the three months ended June 30, 2007 and 2006 was $791,384 and $558,998, respectively. The remaining amount available under the facility was $908,616 at June 30, 2007.

At June 30, 2007, the Company was in compliance with all financial and operational covenants required by the Facility.

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Report of Independent Registered Public Accounting Firm

To the Board of Directors and Shareholders of

Apollo Investment Corporation

We have reviewed the accompanying statements of assets and liabilities of Apollo Investment Corporation (the Company) as of June 30, 2007 and March 31, 2007, including the schedules of investments, the related statements of operations, and of cash flows for the three months ended June 30, 2007 and June 30, 2006 and the statements of changes in net assets for the three-month period ended June 30, 2007 and for the year ended March 31, 2007. These interim financial statements are the responsibility of the Company s management.

We conducted our review in accordance with the standards of the Public Company Accounting Oversight Board (United States). A review of interim financial information consists principally of applying analytical procedures and making inquiries of persons responsible for financial and accounting matters. It is substantially less in scope than an audit conducted in accordance with the standards of the Public Company Accounting Oversight Board, the objective of which is the expression of an opinion regarding the financial statements taken as a whole. Accordingly, we do not express such an opinion.

Based on our review, we are not aware of any material modifications that should be made to the accompanying interim financial statements for them to be in conformity with accounting principles generally accepted in the United States of America.

We have previously audited, in accordance with the standards of the Public Company Accounting Oversight Board (United States), the statement of assets and liabilities as of March 31, 2007, and the related statements of operations, of cash flows and of changes in net assets for the year then ended, management s assessment of the effectiveness of the Company s internal control over financial reporting as of March 31, 2007 and the effectiveness of the Company s internal control over financial reporting as of March 31, 2007; and in our report dated May 29, 2007, we expressed unqualified opinions thereon. The financial statements and management s assessment of the effectiveness of internal control over financial reporting referred to above are not presented herein. In our opinion, the information set forth in the accompanying statement of assets and liabilities as of March 31, 2007, is fairly stated in all material respects in relation to the financial statements from which it has been derived.

PricewaterhouseCoopers LLP
New York, New York
August 8, 2007

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

The following analysis of our financial condition and results of operations should be read in conjunction with our financial statements and the notes thereto contained elsewhere in this report.

Some of the statements in this report constitute forward-looking statements, which relate to future events or our future performance or financial condition. The forward-looking statements contained herein involve risks and uncertainties, including statements as to:

our future operating results;

our business prospects and the prospects of our portfolio companies;

the impact of investments that we expect to make;

our contractual arrangements and relationships with third parties;

the dependence of our future success on the general economy and its impact on the industries in which we invest;

the ability of our portfolio companies to achieve their objectives;

our expected financings and investments;

the adequacy of our cash resources and working capital; and

the timing of cash flows, if any, from the operations of our portfolio companies.

We generally use words such as anticipates, believes, expects, intends and similar expressions to identify forward-looking statements. Our actu results could differ materially from those projected in the forward-looking statements for any reason, including the factors set forth in Risk Factors and elsewhere in this report.

We have based the forward-looking statements included in this report on information available to us on the date of this report, and we assume no obligation to update any such forward-looking statements. Although we undertake no obligation to revise or update any forward-looking statements, whether as a result of new information, future events or otherwise, you are advised to consult any additional disclosures that we may make directly to you or through reports that we in the future may file with the SEC, including any annual reports on Form 10-K, quarterly reports on Form 10-Q and current reports on Form 8-K.

Overview

Apollo Investment was incorporated under the Maryland General Corporation Law in February 2004. We have elected to be treated as a business development company under the Investment Company Act of 1940 (1940 Act). As such, we are required to comply with certain regulatory requirements. For instance, we generally have to invest at least 70% of our total assets in qualifying assets, including securities of private or thinly traded public U.S. companies, cash equivalents, U.S. government securities and high-quality debt investments that mature in one year or less. In addition, for federal income tax purposes we have elected to be treated as a Regulated Investment Company (RIC) under Subchapter M of the Internal Revenue Code of 1986, as amended. Pursuant to this election and assuming we qualify as a RIC, we generally do not have to pay

corporate-level federal income taxes on any income we distribute to our stockholders. Apollo Investment commenced operations on April 8, 2004 upon completion of its initial public offering that raised $870 million in net proceeds selling 62 million shares of its common stock at a price of $15.00 per share.

Investments

Our level of investment activity can and does vary substantially from period to period depending on many factors, including the amount of debt and equity capital available to middle market companies, the level of merger and acquisition activity for such companies, the general economic environment and the competitive environment for the types of investments we make.

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As a business development company, we must not acquire any assets other than qualifying assets specified in the 1940 Act unless, at the time the acquisition is made, at least 70% of our total assets are qualifying assets (with certain limited exceptions). Qualifying assets include investments in eligible portfolio companies. The SEC recently adopted new rules under the 1940 Act to expand the definition of eligible portfolio company to include all private companies and companies whose securities are not listed on a national securities exchange. The new rules also will permit us to include as qualifying assets certain follow-on investments in companies that were eligible portfolio companies at the time of initial investment but that no longer meet the definition. The new rules became effective November 30, 2006. Due to this new rule, we will no longer be required to determine the eligibility of a portfolio company by reference to whether or not it has outstanding marginable securities.

In addition to the adoption of the rules described above, the SEC also proposed for comment a rule that would include as eligible portfolio companies certain public companies that have listed their securities on a national securities exchange, as long as their public float and/or market capitalization are below a specified level. We will continue to monitor closely any developments with respect to the definition of eligible portfolio company, and intend to adjust our investment focus as needed to comply with and/or take advantage of the new rules as well as any other regulatory, legislative, administrative or judicial actions in this area.

Revenue

We generate revenue primarily in the form of interest income from the debt securities we hold and capital gains, if any, on investment securities that we may acquire in portfolio companies. Our debt investments, whether in the form of mezzanine or senior secured loans, generally have a stated term of five to ten years and bear interest at a fixed rate or a floating rate usually determined on the basis of a benchmark: LIBOR, EURIBOR, GBP LIBOR, or the prime rate. While U.S. subordinated debt and corporate notes typically accrue interest at fixed rates, some of these investments may include zero coupon, payment-in-kind (PIK) and/or step-up bonds that accrue income on a constant yield to call or maturity basis. Interest on debt securities is generally payable quarterly or semiannually. In some cases, some of our investments provide for deferred interest payments or PIK. The principal amount of the debt securities and any accrued but unpaid interest generally becomes due at the maturity date. In addition, we may generate revenue in the form of dividends paid to us on equity investments as well as revenue in the form of commitment, origination, structuring fees, fees for providing managerial assistance and, if applicable, consulting fees, etc.

Expenses

All investment professionals of the investment adviser and their staff, when and to the extent engaged in providing investment advisory and management services to us, and the compensation and routine overhead expenses of that personnel which is allocable to those services are provided and paid for by AIM. We bear all other costs and expenses of our operations and transactions, including those relating to:

- investment advisory and management fees;

- expenses incurred by Apollo Investment Management payable to third parties, including agents, consultants or other advisors, in monitoring our financial and legal affairs and in monitoring our investments and performing due diligence on our prospective portfolio companies;

- calculation of our net asset value (including the cost and expenses of any independent valuation firm);

- direct costs and expenses of administration, including auditor and legal costs;

- costs of preparing and filing reports or other documents with the SEC;

- interest payable on debt, if any, incurred to finance our investments;

offerings of our common stock and other securities;

registration and listing fees;

fees payable to third parties, including agents, consultants or other advisors, relating to, or associated with, evaluating and making investments;

transfer agent and custodial fees;

taxes;

independent directors   fees and expenses;

marketing and distribution-related expenses;

the costs of any reports, proxy statements or other notices to stockholders, including printing and postage costs;

- our allocable portion of the fidelity bond, directors and officers/errors and omissions liability insurance, and any other insurance premiums;

- organization and offering; and

- all other expenses incurred by us or Apollo Administration in connection with administering our business, such as our allocable portion of overhead under the administration agreement, including rent and our allocable portion of the cost of our chief financial officer and chief compliance officer and their respective staffs.

We expect our general and administrative operating expenses related to our ongoing operations to increase moderately in dollar terms, but decline slightly as a percentage of our total assets in future periods if our assets grow. Incentive fees, interest expense and costs relating to future offerings of securities, among others, would be additive.

Portfolio and Investment Activity

During the three months ended June 30, 2007, we invested $738.6 million across 13 new and 5 existing portfolio companies. Included in the $738.6 million is our $208 million investment in the preferred and common equity of Grand Prix Holdings, LLC (Innkeepers USA) on June 29, 2007. This compares to investing $286.8 million in 4 new and 5 existing portfolio companies for the three months ended June 30, 2006. Investments sold or prepaid during the three months ended June 30, 2007 totaled $346.9 million versus $124.1 million for the three months ended June 30, 2006.

At June 30, 2007, our net portfolio consisted of 64 portfolio companies and was invested 56% in subordinated debt, 6% in preferred equity, 16% in common equity and warrants and 22% in senior secured loans versus 48 portfolio companies invested 63% in subordinated debt, 3% in preferred equity, 9% in common equity and warrants, and 25% in senior secured loans at June 30, 2006.

The weighted average yields on our subordinated debt portfolio, senior secured loan portfolio and total debt portfolio were 13.1%, 11.9% and 12.8%, respectively, at June 30, 2007 versus 13.6%, 12.7% and 13.3%, respectively, at June 30, 2006.

Senior secured loans and European mezzanine loans typically accrue interest at variable rates determined on the basis of a benchmark: LIBOR, EURIBOR, GBP LIBOR, or the prime rate, with stated maturities at origination that typically range from 5 to 10 years. While subordinated debt issued within the United States will typically accrue interest at fixed rates, some of these investments may include zero-coupon, PIK and/or step bonds that accrue income on a constant yield to call or maturity basis. At June 30, 2007, 66% or $1.6 billion of our debt portfolio is fixed rate debt and 34% or $830.7 million is floating rate debt. At June 30, 2006, 55% or $903.8 million of our interest-bearing portfolio is fixed rate debt and 45% or $725.9 million is floating rate debt.

CRITICAL ACCOUNTING POLICIES

Our discussion and analysis of our financial condition and results of operations are based upon our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States of America, or GAAP. The preparation of these financial statements requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, revenues and expenses. Changes in the economic environment, financial markets and any other parameters used in determining such estimates could cause actual results to differ materially. In addition to the discussion below, our critical accounting policies are further described in the notes to the financial statements.

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Valuation of Portfolio Investments

As a business development company, we generally invest in illiquid securities including debt and equity securities of middle market companies. Under procedures established by our board of directors, we value investments, including certain subordinated debt, senior secured debt and other debt securities with maturities greater than 60 days, for which market quotations are readily available, at such market quotations. We obtain these market quotations from independent pricing services, use the mean between the bid and ask prices obtained from at least two brokers or dealers (if available, otherwise by a principal market maker or a primary market dealer), or by utilizing an independent third party valuation firm. From time to time, we may also utilize independent third party valuation firms to determine fair value if and when such market quotations are deemed not to represent fair value. Debt and equity securities that are not publicly traded or whose market prices are not readily available are valued at fair value as determined in good faith by or under the direction of our board of directors. Such determination of fair values may involve subjective judgments and estimates. Investments purchased within 60 days of maturity are valued at cost plus accreted discount, or minus amortized premium, which approximates value. With respect to unquoted securities, our board of directors, together with our independent valuation advisers value each investment considering, among other measures, discounted cash flow models, comparisons of financial ratios of peer companies that are public and other factors. When an external event such as a purchase transaction, public offering or subsequent equity sale occurs, our board, together with our independent valuation advisers consider the pricing indicated by the external event to corroborate and/or assist us in our valuation. Because we expect that there will not be a readily available market for many of the investments in our portfolio, we expect to value many of our portfolio investments at fair value as determined in good faith by or under the direction of our board of directors using a documented valuation policy and a consistently applied valuation process. Due to the inherent uncertainty of determining the fair value of investments that do not have a readily available fair market value, the value of our investments may differ significantly from the values that would have been used had a readily available market value existed for such investments, and the differences could be material.

With respect to investments for which market quotations are not readily available or when such market quotations are not deemed to represent fair value, our board of directors has approved a multi-step valuation process each quarter, as described below:

- our quarterly valuation process begins with each portfolio company or investment being initially valued by the investment professionals responsible for the portfolio investment;

- preliminary valuation conclusions are then documented and discussed with our senior management;

- independent valuation firms engaged by our board of directors conduct independent appraisals and review management s preliminary valuations and their own independent assessment;

- the audit committee of our board of directors reviews the preliminary valuation of our investment adviser and that of the independent valuation firms and responds and supplements the valuation recommendation of the independent valuation firm to reflect any comments; and

- the board of directors discusses valuations and determines the fair value of each investment in our portfolio in good faith based on the input of our investment adviser, the respective independent valuation firms and the audit committee.

In September, 2006, the Financial Accounting Standards Board issued Statement of Financial Accounting Standards (SFAS) 157, Fair Value Measurements, which assists in clarifying the definition of fair value and requires companies to expand their disclosure about the use of fair value to measure assets and liabilities in interim and annual periods subsequent to initial recognition. Adoption of SFAS 157 requires the use of the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. SFAS 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. At this time, the Company is in the process of reviewing the Standard against its current valuation policies to determine future applicability.

Revenue Recognition

We record interest income on an accrual basis to the extent that we expect to collect such amounts. For loans and debt securities with contractual PIK interest, which represents contractual interest accrued and added to the loan balance that generally becomes due at maturity, we will generally not accrue PIK interest if the portfolio company valuation indicates that the PIK interest is not collectible. We do not accrue as a receivable interest on loans and debt securities if we have reason to doubt our ability to collect such interest. Loan origination fees, original issue discount, and market discount are capitalized and then we amortize such amounts as interest income. Upon the prepayment of a loan or debt security, any unamortized loan origination fees are recorded as interest income. We record prepayment premiums on loans and debt securities as interest income when we receive such amounts.

Net Realized Gains or Losses and Net Change in Unrealized Appreciation or Depreciation

We measure realized gains or losses by the difference between the net proceeds from the repayment or sale and the amortized cost basis of the investment, without regard to unrealized appreciation or depreciation previously recognized, but considering unamortized upfront fees and prepayment penalties. Net change in unrealized appreciation or depreciation reflects the change in portfolio investment values during the reporting period, including the reversal of previously recorded unrealized appreciation or depreciation, when gains or losses are realized.

Within the context of these critical accounting policies, we are not currently aware of any reasonably likely events or circumstances that would result in materially different amounts being reported.

Results of Operations

Results comparisons are for the three months ended June 30, 2007 and June 30, 2006.

Investment Income

For the three months ended June 30, 2007 and June 30, 2006, gross investment income totaled $88.9 million and $55.9 million, respectively. The increase in investment income for the three months ended June 30, 2007 was primarily due to the growth of our investment portfolio as compared to the previous period and the receipt of a $10.0 million structuring fee related to our investment in Grand Prix Holdings, LLC. Origination and commitment fees associated with investments in portfolio companies are accreted into interest income over the respective terms of the applicable loans and accelerated into interest income upon exit, as applicable.

Expenses

Net expenses totaled $34.2 million and $24.1 million, respectively, for the three months ended June 30, 2007 and June 30, 2006, of which $10.8 million and $7.9 million, respectively, were performance-based incentive fees and $7.6 million and $5.6 million, respectively, were interest and other credit facility expenses. Included in the $10.8 million in performance-based incentive fees for the quarter ended June 30, 2007 is a reduction of $2.3 million from the previous quarter s net realized capital gain incentive fee accrual. Changes in net realized gains/losses and changes in gross unrealized depreciation impact the amounts accrued quarter to quarter. The current accrual for the net realized capital gain incentive fee is $19.0 million. Expenses exclusive of performance-based incentive fees, interest, and other credit facility expenses for the three months ended June 30, 2007 and June 30, 2006 were $15.7 million and $10.6 million, respectively. Of these expenses, general and administrative expenses totaled $2.8 million and $2.1 million, respectively, for the three months ended June 30, 2007 and June 30, 2006. Expenses consist of base investment advisory and management fees, insurance expenses, administrative services expenses, professional fees, directors fees, audit and tax services expenses, and other general and administrative expenses. The increase in net expenses was primarily due to an increase in base management fees and performance-based incentive fees, as well as other general and administrative expenses related to the growth of our investment portfolio as compared to the previous period.

Net Investment Income

The Company s net investment income totaled $54.8 million and $31.7 million or $0.53 per share and $0.39 per share, respectively, for the three months ended June 30, 2007 and June 30, 2006.

Net Realized Gains/Losses

The Company had investment sales and prepayments totaling $346.9 million and $124.1 million, respectively, for the three months ended June 30, 2007 and June 30, 2006. Net realized losses for the three months ended June 30, 2007 were $20.7 million, of which $20.1 million was previously recognized as unrealized losses on our interest in Diam International. Net realized losses were $3.0 million for the three month comparative period ended June 30, 2006.

Net Unrealized Appreciation (Depreciation) on Investments, Cash Equivalents and Foreign Currencies

For the three months ended June 30, 2007 and June 30, 2006, the Company s investments, foreign currencies and other assets and liabilities had a net increase in appreciation of $143.7 million and $42.4 million, respectively. A primary component of the $143.7 million was an increase in appreciation on our investment in GS Prysmian Co-Invest LP. At June 30, 2007, net unrealized appreciation totaled $235.9 million, of which $252.5 million was attributable to net unrealized appreciation on our subordinated debt, preferred stock and private equity and $16.6 million was attributable to net unrealized depreciation on our bank debt/senior secured debt (after considering the effects of foreign currency borrowing/hedging for our non-U.S. investments).

Net Increase in Net Assets From Operations

For the three months ended June 30, 2007 and June 30, 2006, the Company had a net increase in net assets resulting from operations of $177.7 million and $71.2 million, respectively. The net change in net assets from operations per share was $1.72 and $0.88, respectively, for the three months ended June 30, 2007 and June 30, 2006.

LIQUIDITY AND CAPITAL RESOURCES

The Company s liquidity and capital resources are generated primarily through its senior secured, multi-currency $1.7 billion, five-year, revolving credit facility maturing in April 2011 as well as from cash flows from operations, including investment sales and prepayments of senior and subordinated loans and income earned from investments and cash equivalents. At June 30, 2007, the Company has $791 million in borrowings outstanding and had $909 million available for its use. In the future, the Company may raise additional equity or debt capital off its shelf registration or may securitize a portion of its investments. The Company may also further access $300 million of additional credit commitments available to it under the terms of its existing credit facility and as the Company s equity capital base grows. The primary use of funds will be investments in portfolio companies, cash distributions to our shareholders and for other general corporate purposes.

	Payments due by Period (dollars in millions)				
	Total	Less than 1 year	1-3 years	3-5 years	More than 5 years
Senior Secured Revolving Credit Facility (1)	$ 791	$	$	$ 791	$

(1) At June 30, 2007, $909 million remained unused under our senior secured revolving credit facility.

Contractual Obligations

We have entered into two contracts under which we have future commitments: the investment advisory and management agreement, pursuant to which Apollo Investment Management has agreed to serve as our investment adviser, and the administration agreement, pursuant to which Apollo Administration has agreed to furnish us with the facilities and administrative services necessary to conduct our day-to-day operations and provide on our behalf managerial assistance to those portfolio companies to which we are required to provide such assistance. Payments under the investment advisory and management agreement are equal to (1) a percentage of the value of our gross assets and (2) a two-part incentive fee. Payments under the administration agreement are equal to an amount based upon our allocable portion of Apollo Administration s overhead in performing its obligations under the administration agreement, including rent, technology systems, insurance and our allocable portion of the costs of our chief financial officer and chief compliance officer and their respective staffs. Either party may terminate each of the investment advisory and management agreement and administration agreement without penalty upon not more than 60 days written notice to the other. Please see Note 3 within our financial statements for more information.

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Off-Balance Sheet Arrangements

On February 28, 2007, the Company entered into Senior Secured Term Loan agreements with Gray Wireline Service Inc., resulting in investments of $40 million in a First Out Term Loan and $70 million in a Second Out Term Loan. In connection with the transaction, the Company also committed to $27.5 million of additional delay draw commitments under the term loans subject to various contingencies and draw down tests. As of June 30, 2007, the Company has $13.0 million of delay draw commitments remaining after the transfer of our interest in the First Out Term Loan and the associated $7.0 million of delay draw commitments during the quarter. Additionally, $7.5 million was drawn by Gray Wireline from the delay draw second out commitment and is reflected in our current $77.5 million position.

At June 30, 2007, we did not have any additional off-balance sheet liabilities or other contractual obligations that are reasonably likely to have a current or future material effect on our financial condition, other than the investment advisory and management agreement and the administration agreement described above.

Dividends

Dividends paid to stockholders for the three months ended June 30, 2007 and June 30, 2006 totaled $52.8 million or $0.51 per share versus $36.5 million or $0.45 per share, respectively. Tax characteristics of all dividends will be reported to shareholders on Form 1099 after the end of the calendar year.

We intend to continue to distribute quarterly dividends to our stockholders. Our quarterly dividends, if any, will be determined by our board of directors.

We have elected to be taxed as a RIC under Subchapter M of the Internal Revenue Code of 1986. To maintain our RIC status, we must distribute at least 90% of our ordinary income and realized net short-term capital gains in excess of realized net long-term capital losses, if any, out of the assets legally available for distribution. In addition, although we currently intend to distribute realized net capital gains (*i.e.*, net long-term capital gains in excess of short-term capital losses), if any, at least annually, out of the assets legally available for such distributions, we may in the future decide to retain such capital gains for investment.

We maintain an opt out dividend reinvestment plan for our common stockholders. As a result, if we declare a dividend, then stockholders cash dividends will be automatically reinvested in additional shares of our common stock, unless they specifically opt out of the dividend reinvestment plan so as to receive cash dividends.

We may not be able to achieve operating results that will allow us to make dividends and distributions at a specific level or to increase the amount of these dividends and distributions from time to time. In addition, we may be limited in our ability to make dividends and distributions due to the asset coverage test for borrowings when applicable to us as a business development company under the 1940 Act and due to provisions in future credit facilities. If we do not distribute a certain percentage of our income annually, we will suffer adverse tax consequences, including possible loss of our RIC status. We cannot assure stockholders that they will receive any dividends and distributions or dividends and distributions at a particular level.

With respect to the dividends paid to shareholders, income from origination, commitment and certain other upfront fees associated with investments in portfolio companies is treated as taxable income and accordingly, distributed to shareholders. For the three months ended June 30, 2007, we received upfront fees totaling $0.1 million, which are being amortized into income over the lives of their respective loans. For the three months ended June 30, 2006, we received upfront fees totaling $2.7 million.

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Item 3. Quantitative and Qualitative Disclosures about Market Risk

We are subject to financial market risks, including changes in interest rates. During the three months ended June 30, 2007, many of the loans in our portfolio had floating interest rates. These loans are usually based on a floating LIBO rate and typically have durations of one to six months after which they reset to current market interest rates. As the percentage of our mezzanine and other subordinated loans increase as a percentage of our total investments, we expect that more of the loans in our portfolio will have fixed rates. Accordingly, we may hedge against interest rate fluctuations by using standard hedging instruments such as futures, options and forward contracts subject to the requirements of the 1940 Act. While hedging activities may insulate us against adverse changes in interest rates, they may also limit our ability to participate in the benefits of lower interest rates with respect to our portfolio of investments. During the three months ended June 30, 2007, we did not engage in interest rate hedging activities.

Item 4. Controls and Procedures

(a) Evaluation of Disclosure Controls and Procedures

As of June 30, 2007 (the end of the period covered by this report), we, including our Chief Executive Officer and Chief Financial Officer, evaluated the effectiveness of the design and operation of our disclosure controls and procedures (as defined in Rule 13a-15(e) of the 1934 Act). Based on that evaluation, our management, including the Chief Executive Officer and Chief Financial Officer, concluded that our disclosure controls and procedures were effective and provided reasonable assurance that information required to be disclosed in our periodic SEC filings is recorded, processed, summarized and reported within the time periods specified in the SECs rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure. However, in evaluating the disclosure controls and procedures, management recognized that any controls and procedures, no matter how well designed and operated can provide only reasonable assurance of achieving the desired control objectives, and management necessarily was required to apply its judgment in evaluating the cost-benefit relationship of such possible controls and procedures.

(b) Changes in Internal Controls Over Financial Reporting

Management has not identified any change in the Company s internal control over financing reporting that occurred during the first quarter of fiscal 2008 that has materially affected, or is reasonably likely to materially affect, the Company s internal control over financial reporting.

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PART II. OTHER INFORMATION

Item 1. Legal Proceedings

We, Apollo Investment Management and Apollo Investment Administration are not currently subject to any material pending legal proceedings.

Item 1A. Risk Factors

The risk factor below restates in its entirety the risk factor set forth under Risk Factors There are significant potential conflicts of interest which could impact our investment returns previously disclosed in our most recent Form 10-K. There have been no other material changes from the risk factors previously disclosed in our most recent Form 10-K filing.

There are significant potential conflicts of interest which could impact our investment returns.

Our executive officers and directors, and the partners of our investment adviser, AIM, serve or may serve as officers, directors or principals of entities that operate in the same or a related line of business as we do or of investment funds managed by our affiliates. Accordingly, they may have obligations to investors in those entities, the fulfillment of which might not be in the best interests of us or our stockholders. Moreover, we note that, notwithstanding the difference in principal investment objectives between Apollo Investment and other Apollo funds, such other Apollo sponsored funds, including new affiliated potential pooled investment vehicles or managed accounts not yet established, have and may from time to time have overlapping investment objectives with those of Apollo Investment and, accordingly, invest in, whether principally or secondarily, asset classes similar to those targeted by Apollo Investment. To the extent such other investment vehicles have overlapping investment objectives, the scope of opportunities otherwise available to us may be adversely affected and/or reduced. As a result, the partners of AIM may face conflicts in their time management and commitments as well as in the allocation of investment opportunities to other Apollo funds. We do not anticipate making an initial investment in any portfolio company in which Apollo or any affiliate has a pre-existing controlling equity investment and we do not anticipate investing in any securities of any company in which Apollo or any of its affiliates has a pre-existing investment in a differing class of securities of such company, save where the opportunity presented to us constitutes a small proportion of the particular tranche of securities and is highly liquid. In addition, in the event such investment opportunities are allocated among Apollo Investment and other investment vehicles affiliated with AIM, our desired investment portfolio may be adversely affected. Although AIM endeavors to allocate investment opportunities in a fair and equitable manner, it is possible that we may not be given the opportunity to participate in certain investments made by investment funds managed by investment managers affiliated with AIM.

There are no information barriers amongst Apollo and certain of its affiliates. If AIM, on behalf of Apollo Investment, were to receive material non-public information about a particular company, it may restrict the ability of Apollo or certain of its affiliates to invest in such company. Conversely, if Apollo or certain of its affiliates were to receive material non-public information about a particular company, Apollo Investment may be restricted in its ability to invest in such company. Consequently, we may not have an opportunity to make certain investments if Apollo or certain of its affiliates have a pre-existing interest in the relevant company or are otherwise restricted from investing in such company.

AIM and its affiliates and investment managers may determine that an investment is appropriate both for us and for one or more other funds. In such event, depending on the availability of such investment and other appropriate factors, AIM may determine that we should invest on a side-by-side basis with one or more other funds. We may make all such investments subject to compliance with applicable regulations and interpretations, and our allocation procedures. Certain types of negotiated co-investments may be made only if we receive an order from the SEC permitting us to do so. There can be no assurance that any such order will be obtained.

In the course of our investing activities, we pay management and incentive fees to AIM, and reimburse AIM for certain expenses it incurs. As a result, investors in our common stock invest on a gross basis and receive distributions on a net basis after expenses, resulting in, among other things, a lower rate of return than one might achieve through direct investments. As a result of this arrangement, there may be times when the management team of AIM has interests that differ from those of our stockholders, giving rise to a conflict.

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AIM receives a quarterly incentive fee based, in part, on our pre-incentive fee income, if any, for the immediately preceding calendar quarter. This incentive fee is subject to a quarterly hurdle rate before providing an incentive fee return to the investment adviser. To the extent we or AIM are able to exert influence over our portfolio companies, the quarterly pre-incentive fee may provide AIM with an incentive to induce our portfolio companies to accelerate or defer interest or other obligations owed to us from one calendar quarter to another.

We have entered into a royalty-free license agreement with Apollo, pursuant to which Apollo has agreed to grant us a non-exclusive license to use the name Apollo. Under the license agreement, we have the right to use the Apollo name for so long as AIM or one of its affiliates remains our investment adviser. In addition, we rent office space from Apollo Administration, an affiliate of AIM, and pay Apollo Administration our allocable portion of overhead and other expenses incurred by Apollo Administration in performing its obligations under the administration agreement, including our allocable portion of the cost of our Chief Financial Officer and Chief Compliance Officer and their respective staffs, which can create conflicts of interest that our board of directors must monitor.

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

None.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Submission of Matters to a Vote of Security Holders

None.

Item 5. Other Information

None.

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Item 6. Exhibits

(a) Exhibits

Listed below are the exhibits that are filed as part of this report (according to the number assigned to them in Item 601 of Regulation S-K):

3.1	Articles of Amendment and Restatement, as amended (1)
3.2	Amended and Restated Bylaws (5)
4.1	Form of Stock Certificate (3)
10.1	Investment Advisory Management Agreement between Registrant and Apollo Investment Management, L.P. (2)
10.1(b)	Supplement to the Investment Advisory Management Agreement between Registrant and Apollo Investment Management, L.P. (5)
10.2	Administration Agreement between Registrant and Apollo Investment Administration, LLC (2)
10.3	Dividend Reinvestment Plan (3)
10.4	Custodian Agreement (3)
10.5	License Agreement between the Registrant and Apollo Management, L.P. (2)
10.6	Form of Transfer Agency and Service Agreement (2)
10.7	Amended and Restated Senior Secured Revolving Credit Agreement (4)
22.1	Proxy Statement (6)
31.1*	Certification of Chief Executive Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
31.2*	Certification of Chief Financial Officer Pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934.
32.1*	Certification of Chief Executive Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).
32.2*	Certification of Chief Financial Officer Pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. 1350).

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* Filed herewith.
(1) Incorporated by reference from the Registrant s post-effective Amendment No. 1 to the Registration Statement under the Securities Act of 1933, as amended, on Form N-2, filed on August 14, 2006.
(2) Incorporated by reference from the Registrant s pre-effective Amendment No. 3 to the Registration Statement under the Securities Act of 1933, as amended, on Form N-2, filed on April 1, 2004.
(3) Incorporated by reference from the Registrant s pre-effective Amendment No. 1 to the Registration Statement under the Securities Act of 1933, as amended, on Form N-2, filed on March 12, 2004.
(4) Incorporated by reference from the Registrant s Form 8-K filed on April 4, 2006.
(5) Incorporated by reference from the Registrant s Form 10-K filed on June 12, 2006.
(6) Incorporated by reference from the Registrant s 14A filed on July 3, 2007.

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SIGNATURES

Pursuant to the requirements of Section 13 or 15(d) 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 on August 8, 2007.

APOLLO INVESTMENT CORPORATION

By: /s/ JOHN J. HANNAN
John J. Hannan
Chief Executive Officer and Director

By: /s/ RICHARD L. PETEKA
Richard L. Peteka
Chief Financial Officer and Treasurer

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