VALERO ENERGY CORPORATION

William R. Klesse
Chief Executive Officer
and Vice Chairman

May 8, 2006

The Honorable Arlen Specter
Chairman
Committee on the Judiciary
United States Senate
224 Dirksen Senate Office Building
Washington, DC 20510

Dear Chairman Specter:

On behalf of Valero Energy Corporation (Valero), thank you for giving me the opportunity to respond to the questions you have submitted on behalf of yourself, Senator DeWine, Senator Feingold, Senator Kohl and Senator Schumer. I also appreciated the opportunity to present Valero's views at your March 14, 2006 hearing on consolidation in the oil and gas industry.

Valero looks forward to working with the Committee. If you have any questions or concerns regarding this submission, please do not hesitate to contact me.

Sincerely,

Bill Klesse

William R. Klesse
Chief Executive Officer and Vice Chairman of the Board

Enclosure

cc: The Honorable Mike DeWine, United States Senator
The Honorable Russ Feingold, United States Senator
The Honorable Herbert Kohl, United States Senator
The Honorable Charles Schumer, United States Senator

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Senator Arlen Specter

1. Please provide an analysis of the draft bill, the "Petroleum Industry Antitrust Act of 2006," which was submitted to the Congressional Record earlier this month.

Answer: Valero understands and respects the motivation that is the basis for the legislation submitted in March 2006. However, Valero has some misgivings about the structure and likely effects of the proposal. Generally, the Act is based on the flawed assumption that concentration in the oil industry is responsible for adverse effects on consumer protection. Today's refining industry is highly competitive. Data do not support the conclusion that acquisitions have increased prices. In fact, we believe companies have become more efficient and continue to compete fiercely. There are 54 refining companies in the U.S., hundreds of wholesale and marketing companies, and more than 165,000 retail outlets.

The biggest U.S. refiner accounts for only about 13 % of the nation's total refining capacity; and the large integrated companies own and operate only about 5 % of all retail outlets. The Federal Trade Commission (FTC) thoroughly evaluates every merger proposal, holds industry mergers to the highest standards of review, and subjects normal industry operations to a higher level of ongoing scrutiny.

In 2004, the FTC published an FTC Staff Study "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement." Among the points made in that publication was the following: "...mergers have contributed to the restructuring of the petroleum industry in the past two decades but have had only a limited impact on industry concentration. The FTC has investigated all major petroleum mergers and required relief when it had reason to believe that a merger was likely to lead to competitive harm..."

The experience of the refining sector is certainly not out of line with other industries. According to data compiled by the U.S. Department of Commerce, in 2003 the four largest U.S. refining companies controlled a little more than 40% of the nation's refining capacity. In contrast, the top four companies in the auto manufacturing, brewing, tobacco, floor coverings and breakfast cereals industries controlled between 80% and 90% of the market. Further, as noted above, several mergers in the refining industry have actively maintained and even increased refining capacity. Without such consolidation, the individual refineries involved might not have been economically viable. Valero alone has increased the productive capacity of the refineries it has acquired by an aggregate of over 500,000 barrels per day over the past several years.

The first section of the proposal - dealing with the criminalization of refusals to sell, diversions or exports - may well be an illegal trade barrier under WTO. Although the volume of petroleum products exported from the United States is not large, a de facto ban on exports would be an indefensible position in a global fuels marketplace. It is axiomatic that in a well-functioning marketplace, sellers choose among potential buyers based upon price. Read most broadly, the proposal seems hostile to this essential market behavior. De facto price controls should be unacceptable. The energy price and allocation controls of the 1970s resulted in supply shortages in the form of long gas lines. Studies have shown that, although intended to reduce costs, controls actually resulted in increased costs and greater inconvenience for consumers. Ultimately, the

refining industry will expand and this action almost assures that the expansions are international to maintain flexibility.

The second section - the prohibition of mergers - is completely unworkable and could be confiscatory under the takings clause of the Constitution. It reduces the test for a violation of the Clayton Act to a question whether an acquisition "may...appreciably diminish competition." This standard is so loose that it could lead to disapproval of almost any acquisition, which would radically diminish the value of the capital assets in question without the just compensation required by the Constitution. We do not believe the proposal constitutes a workable basis for regulating transactions. The dictionary definition of "appreciable" is simply "[p]ossible to estimate, measure, or perceive." This makes the test the regulators would use almost impossible for the regulated community to meet with any certainty.

The legislation's State-Federal task force concept appears flawed on two levels. First, the Committee had laid no predicate for the argument that information is currently shared in impermissible ways. Many analyses seem to contradict that any form of collusive behavior is influencing the fuels market. Second, the task force make-up seems unwieldy. FTC and DOJ must allow any state AG that "chooses to participate" onto the Task Force. There are 56 attorneys general in the United States.

Finally, in the current political environment, waiving OPEC's sovereign immunity, applying extraterritorial jurisdiction, and waiving the act of state doctrine is likely to add further impetus to an already threatening political situation which could well end in retaliation against U.S. commercial interests and further limitations on international free trade.

2. What steps can be taken to decrease consumption of oil and natural gas?

Answer: Valero is not an expert on demand-side policies in the United States. Clearly policies intended to encourage conservation and to enhance energy efficiency are the types of policies designed to decrease consumption of oil and natural gas. Development of true alternative fuels are another such policy, although it is important for Congress to consider the total fuel cycle for such alternatives to make sure that they have a positive energy yield and are cost effective.

3. Please provide an analysis of the incentives offered to petroleum companies by the federal government that explains what the incentives are intended to do, which incentives are important to you, and why they should be maintained.

Answer: It is Valero's understanding that most so-called "incentives" offered to the oil industry deal with oil and gas exploration and production, a sector of the industry in which Valero does not participate. By contrast, Valero's most important product – gasoline for use as a motor fuel – is actually subject to a hefty federal excise tax. That said, to the extent that incentives do spur on additional production that can be made available to refiners, we are generally supportive of such policies as a means to enhance supply of our major input, crude petroleum. An investment tax credit can be equally applied and will create more jobs and supplies.

4. In the two weeks prior to March 14, 2006, the price of oil decreased seven cents per gallon, while the price of gasoline increased by eleven cents per gallon. Why would gasoline become more expensive during this period, despite a decrease in the cost of crude oil?

Answer: As the Committee heard, the price of crude oil is a significant factor determining the price of refined product in the marketplace. However, reductions in crude prices often do not translate directly into gasoline price reductions at the pump in the short term. One market complexity is that contracts for a particular delivery term may be predicated on prices at the time the contract was entered. Even in the spot market, continued uncertainty can keep prices relatively high even as market participants react to decreasing crude prices. Of course, over time, sustained reductions in crude input costs result in sustained price stability for consumers. It is always about supply and demand for a particular commodity – crude oil or refined products.

5. With respect to the larger mergers that your companies have engaged in over the past decade, what efficiencies have they produced that have benefited the consumer, particularly in downstream markets?

Answer: As we have testified, Valero is a "pure play" refiner so we are in a good position to discuss the consumer benefits that have flowed from our acquisition of refinery assets. Specifically, Valero has increased the capacity of its 18 refineries by almost 20 percent since acquiring them, adding 533,000 barrels per day of refining capacity. That's the equivalent of building three world-scale grassroots refineries. We have also added and expanded existing units that allow us to process a wider variety of crudes. It's fair to say that if Valero had not acquired these refineries, much of this capacity expansion would not have occurred, and some facilities might have closed.

Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years. And new regulations continue to be drafted and adopted.

Valero has learned that a responsible policy of strategic acquisitions can allow for a refiner to optimize the performance of the acquired facilities to allow for performance that the previous owner did not achieve. Growth proceeds through acquisition of refineries well below their replacement cost in the marketplace. Then, Valero typically optimizes, upgrades and expands the acquired refineries, to the benefit of shareholder and consumer alike.

Senator DeWine

1. At our last hearing, we heard testimony that some of the gasoline price spikes can be attributed to regulations that create multiple grades of gasoline to comply with different environmental standards — so called "boutique fuels." What can we do to reduce the number of boutique fuels? What would be the effect of just requiring everyone in the industry to comply with the highest standard, and have just one fuel available?

Answer: Valero well understands the complexities that can face production and distribution of gasoline when fuel regulations result in balkanization of the market. The more fungible the gasoline, the easier it is to bring gasoline to market. That said, some states and localities based their requests for special gasoline blends on a desire to achieve clean-air benefits while minimizing the costs associated with other clean-fuel formulations. Therefore, it is not always the case that a so-called "boutique" fuel is more costly to the consumer than the fuel environmental controls would otherwise dictate.

If the Congress were to limit fuel choice to the "highest" standard, the result would eliminate barriers to fungibility but at a very high cost to consumers. Such a move would heighten demand for certain blendstocks, while excluding other relatively clean blendstocks from the marketplace. The net result would be to shrink the national fuel pool to the detriment of consumers.

2. In the last couple of months most of the oil industry has announced record-breaking profits for the last fiscal year. How much is your company investing annually in exploration, production and refining, and when will we see those investments pay off? And perhaps most important, what are you investing in alternative energy sources so we can help reduce domestic dependence on foreign oil?

Answer: As we have testified, Valero is a "pure play" refiner and does not engage in oil and gas exploration and development and while marketing of gasoline is important to Valero, it only represents about 10 percent of the Corporation's assets. Therefore, Valero is in a good position to discuss the consumer benefits that have flowed from its acquisition of refinery assets.

Improving refineries takes expertise and capital and Valero has more in-house expertise with greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years. And new regulations continue to be drafted and adopted.

Valero has learned that a responsible policy of strategic acquisitions can allow for a refiner to optimize the performance of the acquired facilities to allow for performance that the previous owner did not achieve. Growth proceeds through acquisition of refineries well below their replacement cost in the marketplace. Then, Valero typically optimizes, upgrades and expands the acquired refineries, to the benefit of shareholder and consumer alike.

As for investments in alternative energy, Valero is coming to grips with the implementation of the Energy Policy Act of 2005. As you know, that Act contains a significant renewable fuels mandate with which Valero will comply to the full extent of the law. Valero has long been an innovator in the production of new fuels. Valero is recognized throughout the industry as a leader in the production of premium, clean-burning fuels such as reformulated gasoline, CARB Phase II gasoline, low-sulfur diesel and oxygenates.

Senator Feingold

1. On February 1, 2006, while this Committee was conducting its first hearing related to consolidation in the oil and gas industry, reports came out that Valero Energy Corporation had restricted output from a refinery in Ohio by more that 10 percent because of lower profit margins. In late January, BP cut production between 10-15 percent at an Indiana refinery. These actions appear to indicate that reductions in the number of refineries have nothing to do with high prices, as some have indicated. In the face of record profits, why did your companies reduce refinery output?

Answer: Valero strongly disagrees with the premise of the question that we cut production because of low profit margins. First, we made every effort to keep our conversion units full so that our gasoline production at the Lima, Ohio, refinery would be maintained at approximately the same level. Since we kept our conversion units full, it was obviously not a decision to reduce gasoline production because our gasoline yield is about the same. Valero did not cut gasoline production but in fact inventories in that area of the country are at 5-year highs.

The product reduction was for high-sulfur diesel (off road diesel) which there is little market for at the time of year in question. Such fuel is primarily sold for use in agricultural equipment and obviously there is not much agricultural work in the winter in areas typically served by the Lima refinery. As in years past crude runs were cut because there was no additional demand for diesel in the months where agricultural demand is reduced.

2. The President mentioned in his state of the union address that America is "addicted to oil", and outlined several steps – including increasing investments in alternative fuels – to end the addiction. What percentage of your R&D is dedicated to alternatives? In your response, please indicate how your company defines alternatives. In addition to your R&D, what are your companies doing, as corporate citizens, to move away from fossil fuels?

Answer: As we have testified, Valero is a "pure play" refiner and does not engage in oil and gas exploration, nor does Valero have a research and development division looking into alternative fuels. Given that Valero is not an integrated oil company, it has focused its investment strategy largely in the refining sector. Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years.

Valero works diligently to ensure a reliable supply of an essential commodity for our nation and we do so while maintaining the highest standard of safety for our employees and a commitment to the environment and the community. We take great pride in our corporate citizenship. In 2005, our employees gave over $12 million to the United Way and volunteered in their communities more than 220,000 hours. However, we do not believe that moving away from our core business of refining falls under the realm of corporate citizenship.

Senator Kohl

1. Valero's profits from last year exceeded $3.6 billion. And we all know how sharply gas prices rose last year, exceeding $3 dollars per gallons in many places last summer. You and your colleagues in the oil industry have placed most of the blame on the worldwide price of crude oil, arguing that you must pay higher and higher prices from the world market to obtain the crude oil you refine into gasoline, heating oil and other petroleum products. But somehow as the price you paid for this raw material rose, your profits also rose. This seems odd to me – in most competitive industries profits fall, not rise, as the price of their raw materials rise. For example, the airline industry has seen the cost of the jet fuel it must use rise sharply. This has not resulted in profits for the airline industry, but instead huge losses and bankruptcy for many airlines.

So how can it be that your profits have reached record levels as the worldwide price of crude has risen? How can the industry's profits rise as the price for the raw material it uses to make its products increases?

Answer: Respectfully, Valero does not believe the comparison drawn in the question leads to an accurate inference. The refining industry and the airline industry are simply too dissimilar as economic sectors for valid comparisons to be made; the former is a commodity industry with largely inelastic demand; the latter is neither one, and many airlines have an outdated and inefficient business model that can not compete with new entrants. In the refining industry, price increases are typically precipitated by relative scarcity or uncertainty in the crude markets. Under laws of supply and demand, this scarcity is then reflected in available stocks of finished products. While the cost of the crude inputs increase, such costs are reflected in the price of the finished product. However, the relative scarcity conditions also improve refining margins, as they would in any other commodity industry as finished refined products have their own supply/demand balance, and crude oil is a derived supply/demand balance because crude oil must be refined.

Refining margins may be healthy now. However, in the ten-year period 1993-2002, average return on investment in the refining industry was only about 5.5%. This is less than half of the S&P industrials average return of 12.7% for the same period. Refining industry profits as a percentage of operating capital are not excessive. In dollars, they seem large due to the massive scale needed to compete in a large, capital-intensive industry. For example, a new medium scale refinery (100,000 to 200,000 b/d) would cost $2 to $4 billion. In short, company revenues can be in the billions, but so, too are the costs of operations.

When refining margins improve, more capital is available for investment in the sector, including capacity expansion and regulatory compliance. The Federal Trade Commission found in June 2005 that, "Profits play necessary and important roles in a well functioning market economy. Recent oil company profits are high but have varied widely over time, over industry segments and among firms...Profits also compensate firms for taking risks, such as the risks in the oil industry that war or terrorism may destroy crude production assets or, that new environmental requirements may require substantial new refinery capital investments."

2. An independent study by the consumers group Public Citizen found that from 1999 to 2004 U.S. oil refiners increased their profits they made on each gallon of gas refined by 79%. Don't these statistics show that it is not merely the rising worldwide cost of crude oil that accounts for high prices and other petroleum products? And does the success of your industry in passing along rising crude oil prices to consumer demonstrate that your companies have gained market power and that there is a failure of competition in this market?

Answer: The Valero experience has shown that acquisitions allow us to bring more capacity to market, thus benefiting consumers. Valero has increased the capacity of its 18 refineries by almost 20 percent since acquiring them, adding 533,000 barrels per day of refining capacity. That's the equivalent of building three world-scale grassroots refineries. We have also added and expanded existing units that allow us to process a wider variety of crudes. It's fair to say that if Valero had not acquired these refineries, much of this capacity expansion would not have occurred, and some facilities might have closed.

Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years.

3. In the last 15 years there has been a tremendous amount of consolidation in the oil industry – the GAO counts 2600 mergers and acquisitions in this industry since the 1990s alone. Indeed, almost all of the companies represented here today are a product of these mergers. During this time, the FTC has approved most of the oil industry mergers it has reviewed, including the gigantic ones like Exxon/Mobil, Chevron/Texaco, and Conoco/Phillips. While each one of these mergers may not have seemed problematic when reviewed, taken as a whole these mergers have greatly increased concentration in the industry. And the GAO has concluded that these mergers have raised gasoline prices.

(a) What is your view of the effects of these mergers on competition in your industry and the price of petroleum products?

Answer: See answer to Question No. 2 above for a discussion of Valero's experience with acquisitions resulting in tangible increases in refining capacity, to the great benefit of consumers. Beyond that experience, Valero respectfully disagrees with the premise of the question. As a general rule, today's refining industry appears to us as highly competitive. Data do not support the conclusion that acquisitions have increased prices. In fact, we believe companies have become more efficient and continue to compete fiercely. There are 54 refining companies in the U.S., hundreds of wholesale and marketing companies, and more than 165,000 retail outlets.

The biggest refiner accounts for only about 13 % of the nation's total refining capacity; and the large integrated companies own and operate only about 5 % of all retail outlets. The Federal Trade Commission (FTC) thoroughly evaluates every merger proposal, holds industry mergers to the

highest standards of review, and subjects normal industry operations to a higher level of ongoing scrutiny. In 2004 the FTC published a staff study entitled, "The Petroleum Industry: Mergers, Structural Change, and Antitrust Enforcement." Among the points made in that publication was the following: "...mergers have contributed to the restructuring of the petroleum industry in the past two decades but have had only a limited impact on industry concentration. The FTC has investigated all major petroleum mergers and required relief when it had reason to believe that a merger was likely to lead to competitive harm..."

(b) Are we likely to see even more consolidation in the years ahead? If so, what will this mean for competition in this industry?

Answer: As we stated at the hearing, Valero is a growth company that will continue to evaluate acquisition opportunities for consistency with the Valero business model. As noted in our answer to Question No. 2 above, it has been Valero's consistent experience that it has increased the capacity of each of the refineries it has acquired, to the benefit of consumers, workers, and shareholders.

Senator Charles Schumer

1. Would you please clarify which income figures your company reported to the internal revenue services last year for tax purposes, as well as the basis for those figures? Are these the same income figures reported to your shareholders? If different figures were used, what were they, what was their basis, and what is the rationale for this decision?

Answer: The US income figures reported to our shareholders serve as the starting point for the determination of the taxable income figures that Valero reported to the Internal Revenue Service last year for tax purposes. In addition, the Company reported to the Internal Revenue Service the book/tax differences in reported income and expense amounts that it is currently entitled to pursuant to the US Internal Revenue Code. All such amounts are subject to an annual audit by the Internal Revenue Service.

2. Based on your written testimony, it appears that your company has put at most 5% of annual investment toward developing alternative energy technologies like hydrogen fuel cells, wind, solar, and others. What is the rationale for this investment strategy? Have you decided that investment in these energy sources is not in the interest of your shareholders?

Answer: As we have testified, Valero is a "pure play" refiner and does not engage in oil and gas exploration and development. While marketing of gasoline is important to Valero, it only represents about 10 percent of the Corporation's assets. Therefore, Valero is in a good position to discuss the consumer benefits that have flowed from its acquisition of refinery assets.

Given that Valero is not an integrated oil company, it has focused its investment strategy largely in the refining sector. Improving refineries takes expertise and capital and Valero has more in-house expertise and greater access to capital than many of the companies from which we have purchased refineries. In the past this has made expansion easier while meeting costly regulatory requirements. Valero has invested approximately $8.2 billion to improve its refineries. These investments have yielded tangible results for consumers, shareholders and workers alike: Valero has increased the capacity of its 18 refineries by almost 20 percent since acquiring them, adding 533,000 barrels per day of refining capacity. That's the equivalent of building three world-scale grassroots refineries.

Since 1997, we have spent $2.4 billion on regulatory and environmental compliance. To comply with probable regulatory and fuel specifications, we will need to spend another $3.5 billion over the next several years. And new regulations continue to be drafted and adopted.

Valero has learned that a responsible policy of strategic acquisitions can allow for a refiner to optimize the performance of the acquired facilities to allow for performance that the previous owner did not achieve. Growth proceeds through acquisition of refineries well below their replacement cost in the marketplace. Then, Valero typically optimizes, upgrades and expands the acquired refineries, to the benefit of shareholder and consumer alike.

As for investments in alternative energy, Valero is coming to grips with the implementation of the Energy Policy Act of 2005. As you know, that Act contains a significant renewable fuels mandate

with which Valero will comply to the full extent of the law. Valero has long been an innovator in the production of new fuels. Valero is recognized throughout the industry as a leader in the production of premium, clean-burning fuels such as reformulated gasoline, CARB Phase II gasoline, low-sulfur diesel and oxygenates.

3. How much royalty relief have you received from the Department of Interior for exploration on pubic lands? Which public lands specifically? At what price threshold have you predicted internally that you would not need royalty relief to make exploration viable?

Answer: Valero does not engage in oil and gas exploration and development. Therefore, we have received no royalty relief.