VALERO ENERGY CORP/TX
Form 10-Q
May 08, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549
FORM 10-Q
(Mark One)
R QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the Quarterly Period Ended March 31, 2014
OR
o 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	74-1828067
(State or other jurisdiction of incorporation or organization)	(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 R No o
Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes R No o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act.
Large accelerated filer R Accelerated filer o Non-accelerated filer o Smaller reporting company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
Yes o No R
The number of shares of the registrant's only class of common stock, $0.01 par value, outstanding as of April 30, 2014 was 533,624,161.

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PART I – FINANCIAL INFORMATION
Item 1. Financial Statements

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

	March 31, 2014 (Unaudited)	December 31, 2013
ASSETS		
Current assets:		
Cash and temporary cash investments	$3,647	$4,292
Receivables, net	7,783	8,751
Inventories	7,106	5,758
Income taxes receivable	104	72
Deferred income taxes	256	266
Prepaid expenses and other	134	138
Total current assets	19,030	19,277
Property, plant, and equipment, at cost	34,235	33,933
Accumulated depreciation	(8,469)	(8,226)
Property, plant, and equipment, net	25,766	25,707
Deferred charges and other assets, net	2,303	2,276
Total assets	$47,099	$47,260
LIABILITIES AND EQUITY		
Current liabilities:		
Current portion of debt and capital lease obligations	$704	$303
Accounts payable	9,617	9,931
Accrued expenses	488	522
Taxes other than income taxes	1,139	1,345
Income taxes payable	667	773
Deferred income taxes	311	249
Total current liabilities	12,926	13,123
Debt and capital lease obligations, less current portion	5,860	6,261
Deferred income taxes	6,615	6,601
Other long-term liabilities	1,290	1,329
Commitments and contingencies		
Equity:		
Valero Energy Corporation stockholders' equity:		
Common stock, $0.01 par value; 1,200,000,000 shares authorized; 673,501,593 and 673,501,593 shares issued	7	7
Additional paid-in capital	7,134	7,187
Treasury stock, at cost; 140,081,386 and 137,932,138 common shares	(7,168)	(7,054)
Retained earnings	19,665	18,970
Accumulated other comprehensive income	277	350
Total Valero Energy Corporation stockholders' equity	19,915	19,460
Noncontrolling interests	493	486
Total equity	20,408	19,946
Total liabilities and equity	$47,099	$47,260

See Condensed Notes to Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2014	2013
Operating revenues	$33,663	$33,474
Costs and expenses:		
Cost of sales	30,630	30,685
Operating expenses:		
Refining	973	876
Retail	—	169
Ethanol	129	77
General and administrative expenses	160	176
Depreciation and amortization expense	421	430
Total costs and expenses	32,313	32,413
Operating income	1,350	1,061
Other income, net	15	14
Interest and debt expense, net of capitalized interest	(100)	(83)
Income before income tax expense	1,265	992
Income tax expense	429	340
Net income	836	652
Less: Net income (loss) attributable to noncontrolling interests	8	(2)
Net income attributable to Valero Energy Corporation stockholders	$828	$654
Earnings per common share	$1.55	$1.18
Weighted-average common shares outstanding (in millions)	531	550
Earnings per common share – assuming dilution	$1.54	$1.18
Weighted-average common shares outstanding – assuming dilution (in millions)	536	556
Dividends per common share	$0.25	$0.20

See Condensed Notes to Consolidated Financial Statements.

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

	Three Months Ended March 31,	
	2014	2013
Net income	$836	$652
Other comprehensive income (loss):		
Foreign currency translation adjustment	(74)	(204)
Net gain (loss) on pension and other postretirement benefits	(2)	336
Net gain (loss) on derivative instruments designated and qualifying as cash flow hedges	4	(2)
Other comprehensive income (loss) before income tax expense	(72)	130
Income tax expense related to items of other comprehensive income (loss)	1	117
Other comprehensive income (loss)	(73)	13
Comprehensive income	763	665
Less: Comprehensive income (loss) attributable to noncontrolling interests	8	(2)
Comprehensive income attributable to Valero Energy Corporation stockholders	$755	$667

See Condensed Notes to Consolidated Financial Statements.

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VALERO ENERGY CORPORATION
CONSOLIDATED STATEMENTS OF CASH FLOWS
(Millions of Dollars)
(Unaudited)

	Three Months Ended March 31, 2014	2013
Cash flows from operating activities:		
Net income	$836	$652
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization expense	421	430
Deferred income tax expense	88	173
Changes in current assets and current liabilities	(1,088)	255
Changes in deferred charges and credits and other operating activities, net	(13)	39
Net cash provided by operating activities	244	1,549
Cash flows from investing activities:		
Capital expenditures	(388)	(577)
Deferred turnaround and catalyst costs	(129)	(287)
Other investing activities, net	(41)	4
Net cash used in investing activities	(558)	(860)
Cash flows from financing activities:		
Repayment of debt	—	(180)
Proceeds from the exercise of stock options	24	38
Purchase of common stock for treasury	(226)	(304)
Common stock dividends	(133)	(111)
Contributions from noncontrolling interests	—	13
Distributions to public unitholders of Valero Energy Partners LP	(1)	—
Other financing activities, net	24	22
Net cash used in financing activities	(312)	(522)
Effect of foreign exchange rate changes on cash	(19)	(33)
Net increase (decrease) in cash and temporary cash investments	(645)	134
Cash and temporary cash investments at beginning of period	4,292	1,723
Cash and temporary cash investments at end of period	$3,647	$1,857

See Condensed Notes to Consolidated Financial Statements.

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VALERO ENERGY CORPORATION
CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. BASIS OF PRESENTATION AND SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Basis of Presentation

As used in this report, the terms “Valero,” “we,” “us,” or “our” may refer to Valero Energy Corporation, one or more of its consolidated subsidiaries, or all of them taken as a whole.

These unaudited financial statements have been prepared in accordance with United States (U.S.) 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 U.S. GAAP for complete financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal recurring nature unless disclosed otherwise. Financial information for the three months ended March 31, 2014 and 2013 included in these Condensed Notes to Consolidated Financial Statements is derived from our unaudited financial statements. Operating results for the three months ended March 31, 2014 are not necessarily indicative of the results that may be expected for the year ending December 31, 2014.

The balance sheet as of December 31, 2013 has been derived from our audited financial statements as of that date. For further information, refer to our financial statements and notes thereto included in our annual report on Form 10-K for the year ended December 31, 2013.

Significant Accounting Policies

Use of Estimates

The preparation of financial statements in conformity with U.S. GAAP requires us to make estimates and assumptions that affect the amounts reported in the financial statements and accompanying notes. Actual results could differ from those estimates. On an ongoing basis, we review our estimates based on currently available information. Changes in facts and circumstances may result in revised estimates.

Income Taxes

In July 2013, the provisions of Accounting Standards Codification (ASC) Topic 740, “Income Taxes,” were amended to provide specific guidance on the financial statement presentation of an unrecognized tax benefit when a net operating loss carryforward, a similar tax loss, or a tax credit carryforward exists at the reporting date. The amendment requires entities to present an unrecognized tax benefit as a reduction to the deferred tax asset generated by the net operating loss carryforward, similar tax loss, or tax credit carryforward, if such items are available to be used to offset the unrecognized tax benefit. These provisions are effective for interim and annual reporting periods beginning after December 15, 2013 and should be applied prospectively to all unrecognized tax benefits that exist at the effective date, with retrospective application permitted. The adoption of this guidance effective January 1, 2014 did not affect our financial position or results of operations, nor did it require any additional disclosures.

New Accounting Pronouncement

In April 2014, the provisions of ASC Topic 205, “Presentation of Financial Statements,” and ASC Topic 360, “Property, Plant, and Equipment,” were amended to change the criteria for reporting discontinued operations. The provisions of these amendments modify the definition of discontinued operations by limiting discontinued operations reporting to disposals of components of an entity that represent strategic shifts that have or will have a major effect on an entity’s operations and financial results. These amendments require additional disclosures about discontinued operations and new disclosures for other disposals of individually

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

material components of an organization that do not meet the definition of a discontinued operation. In addition, the guidance allows companies to have significant continuing involvement and continuing cash flows with the discontinued operation. These provisions are effective prospectively for annual reporting periods beginning on or after December 15, 2014, and interim periods within those annual periods, with early adoption permitted. The adoption of this guidance effective January 1, 2015 will not affect our financial position or results of operations; however, it may result in changes to the manner in which future dispositions of operations or assets, if any, are presented in our financial statements, or it may require additional disclosures.

2. VALERO ENERGY PARTNERS LP

In July 2013, we formed Valero Energy Partners LP (VLP), a master limited partnership, to own, operate, develop, and acquire crude oil and refined petroleum products pipelines, terminals, and other transportation and logistics assets. On December 16, 2013, VLP completed its initial public offering (the Offering) of 17,250,000 common units at a price of $23.00 per unit. VLP received $369 million in net proceeds from the sale of the units, after deducting underwriting fees, structuring fees, and other offering costs. VLP’s assets include crude oil and refined petroleum products pipeline and terminal systems in the U.S. Gulf Coast and U.S. Mid-Continent regions that are integral to the operations of our Port Arthur, McKee, and Memphis Refineries.

As of March 31, 2014 and December 31, 2013, we owned a 68.6 percent limited partner interest and a 2 percent general partner interest in VLP, and the public owned a 29.4 percent limited partner interest. VLP’s cash and temporary cash investments were $384 million and $375 million as of March 31, 2014 and December 31, 2013, respectively. Valero consolidates the financial statements of VLP into its financial statements and as such, VLP’s cash and temporary cash investments are included in Valero’s consolidated cash and temporary cash investments. However, VLP’s cash and temporary cash investments can be used only to settle its obligations. In addition, VLP’s partnership capital attributable to the public’s ownership interest in VLP of $372 million and $370 million as of March 31, 2014 and December 31, 2013, respectively, is reflected in noncontrolling interests.

We have agreements with VLP that establish fees for certain general and administrative services, and operational and maintenance services provided by us. In addition, we have a master transportation services agreement and a master terminal services agreement with VLP where VLP provides commercial transportation and terminaling services to us. These transactions are eliminated in consolidation.

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

3. INVENTORIES

Inventories consisted of the following (in millions):

	March 31, 2014	December 31, 2013
Refinery feedstocks	$3,500	$2,135
Refined products and blendstocks	3,129	3,231
Ethanol feedstocks and products	247	166
Materials and supplies	230	226
Inventories	$7,106	$5,758

As of March 31, 2014 and December 31, 2013, the replacement cost (market value) of last in, first out (LIFO) inventories exceeded their LIFO carrying amounts by approximately $7.1 billion and $6.9 billion, respectively. As of March 31, 2014 and December 31, 2013, our non-LIFO inventories accounted for $924 million and $851 million, respectively, of our total inventories.

4. DEBT

Credit Facilities
Revolver
We have a $3 billion revolving credit facility (the Revolver) that has a maturity date of November 2018. We have the option to increase the aggregate commitments under the Revolver to $4.5 billion, subject to, among other things, the consent of the existing lenders whose commitments will be increased or any additional lenders providing such additional capacity. The Revolver has certain restrictive covenants, including a maximum debt-to-capitalization ratio of 60 percent. As of March 31, 2014 and December 31, 2013, our debt-to-capitalization ratios, calculated in accordance with the terms of the Revolver, were 14 percent and 12 percent, respectively. We believe that we will remain in compliance with this covenant.

VLP Revolver
VLP has a $300 million senior unsecured revolving credit facility agreement (the VLP Revolver) that has a maturity date of December 2018. The VLP Revolver is available only to the operations of VLP, and creditors of VLP do not have recourse against Valero. VLP has the option to increase the aggregate commitments under the VLP Revolver to $500 million, subject to, among other things, the consent of the existing lenders whose commitments will be increased or any additional lenders providing such additional capacity. VLP’s obligations under the VLP Revolver will be jointly and severally guaranteed by all of VLP’s directly owned material subsidiaries. As of March 31, 2014 and December 31, 2013, the only guarantor under the VLP Revolver was Valero Partners Operating Co. LLC, a wholly owned subsidiary of VLP. The VLP Revolver has certain restrictive covenants, including a ratio of total debt to EBITDA (as defined in the VLP Revolver) for the prior four fiscal quarters of not greater than 5.0 to 1.0 as of the last day of each fiscal quarter, and limitations on VLP’s ability to pay distributions to its unitholders. As of March 31, 2014, VLP’s debt to EBITDA ratio, calculated in accordance with the terms of the VLP Revolver, was 0.1 to 1.0. We believe that VLP will remain in compliance with this covenant.

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

Canadian Facility
In addition to the Revolver and the VLP Revolver, one of our Canadian subsidiaries has a C$50 million committed revolving credit facility under which it may borrow and obtain letters of credit that has a maturity date of November 2014.

Activities Under Our Credit Facilities
During the three months ended March 31, 2014 and 2013, we had no borrowings or repayments under the Revolver, the VLP Revolver, or our Canadian revolving credit facility. As of March 31, 2014 and December 31, 2013, we had no borrowings outstanding under the Revolver, the VLP Revolver, or our Canadian revolving credit facility.

We had outstanding letters of credit under our committed lines of credit as follows (in millions):

	Borrowing Capacity	Expiration	Amounts Outstanding March 31, 2014	December 31, 2013
Letter of credit facilities	$ 550	June 2014	$ 258	$ 278
Revolver	$ 3,000	November 2018	$ 59	$ 59
VLP Revolver	$ 300	December 2018	$ —	$ —
Canadian revolving credit facility	C$50	November 2014	C$10	C$10

As of March 31, 2014 and December 31, 2013, we had $414 million and $189 million, respectively, of letters of credit outstanding under our uncommitted short-term bank credit facilities.

Non-Bank Debt
We made no scheduled debt repayments during the three months ended March 31, 2014, but we made a scheduled debt repayment of $200 million related to our 4.75% senior notes in April 2014. During the three months ended March 31, 2013, we made a scheduled debt repayment of $180 million related to our 6.7% senior notes.

Accounts Receivable Sales Facility
We have an accounts receivable sales facility with a group of third-party entities and financial institutions to sell up to $1.5 billion of eligible trade receivables on a revolving basis. In July 2013, we amended this facility to extend the maturity date to July 2014. Proceeds from the sale of receivables under this facility are reflected as debt. Under this program, one of our marketing subsidiaries (Valero Marketing) sells eligible receivables, without recourse, to another of our subsidiaries (Valero Capital), whereupon the receivables are no longer owned by Valero Marketing. Valero Capital, in turn, sells an undivided percentage ownership interest in the eligible receivables, without recourse, to the third-party entities and financial institutions. To the extent that Valero Capital retains an ownership interest in the receivables it has purchased from Valero Marketing, such interest is included in our financial statements solely as a result of the consolidation of the financial statements of Valero Capital with those of Valero Energy Corporation; the receivables are not available to satisfy the claims of the creditors of Valero Marketing or Valero Energy Corporation.

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

During the three months ended March 31, 2014 and 2013, we had no proceeds from or repayments under our accounts receivable sales facility. As of March 31, 2014 and December 31, 2013, we had $100 million outstanding under our accounts receivable sales facility.

Capitalized Interest
Capitalized interest was $17 million and $40 million for the three months ended March 31, 2014 and 2013, respectively.

5. COMMITMENTS AND CONTINGENCIES

Environmental Matter
We are involved, together with several other companies, in an environmental cleanup in the Village of Hartford, Illinois (the Village) and the adjacent shutdown refinery site, which we acquired as part of a prior acquisition. In cooperation with some of the other companies, we have been conducting initial mitigation and cleanup response pursuant to an administrative order issued by the U.S. Environmental Protection Agency (EPA). The EPA is seeking further cleanup obligations from us and other potentially responsible parties for the Village. In parallel with the Village cleanup, we are also in litigation with the State of Illinois Environmental Protection Agency and other potentially responsible parties relating to the remediation of the shutdown refinery site. In each of these matters, we have various defenses and rights for contribution from the other responsible parties. We have accrued for our own expected contribution obligations. However, because of the unpredictable nature of these cleanups and the methodology for allocation of liabilities, it is reasonably possible that we could incur a loss in a range of $0 to $200 million in excess of the amount of our accrual to ultimately resolve these matters. Factors underlying this estimated range are expected to change from time to time, and actual results may vary significantly from this estimate.

Litigation Matters
We are party to claims and legal proceedings arising in the ordinary course of business. We have not recorded a loss contingency liability with respect to some of these matters because we have determined that it is remote that a loss has been incurred. For other matters, we have recorded a loss contingency liability where we have determined that it is probable that a loss has been incurred and that the loss is reasonably estimable. These loss contingency liabilities are not material to our financial position. We re-evaluate and update our loss contingency liabilities as matters progress over time, and we believe that any changes to the recorded liabilities will not be material to our financial position, results of operations, or liquidity.

Aruba Refinery
During 2012, we suspended the operations of the Aruba Refinery and recognized an impairment loss with respect to all of the refinery’s long-lived assets, except for certain terminal assets that we continue to operate. We have not, however, abandoned the refinery. Should we ultimately decide to abandon the refinery, we may be required under our land lease agreement with the Government of Aruba to dismantle and remove the abandoned assets. This would require us to recognize an asset retirement obligation that would be charged to expense. We do not expect these amounts to be material to our financial position or results of operations.

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

6. EQUITY

Reconciliation of Balances
The following is a reconciliation of the beginning and ending balances of equity attributable to our stockholders, equity attributable to the noncontrolling interests, and total equity (in millions):

	Three Months Ended March 31,					
	2014			2013		
	Valero Stockholders' Equity	Non-controlling Interests	Total Equity	Valero Stockholders' Equity	Non-controlling Interests	Total Equity
Balance as of beginning of period	$19,460	$486	$19,946	$18,032	$63	$18,095
Net income (loss)	828	8	836	654	(2)	652
Dividends	(133)	—	(133)	(111)	—	(111)
Stock-based compensation expense	10	—	10	11	—	11
Tax deduction in excess of stock-based compensation expense	25	—	25	24	—	24
Transactions in connection with stock-based compensation plans:						
Stock issuances	24	—	24	38	—	38
Stock repurchases	(17)	—	(17)	(24)	—	(24)
Stock repurchases under buyback program	(209)	—	(209)	(294)	—	(294)
Contributions from noncontrolling interests	—	—	—	—	14	14
Distributions to public unitholders of Valero Energy Partners LP	—	(1)	(1)	—	—	—
Other comprehensive income (loss)	(73)	—	(73)	13	—	13
Balance as of end of period	$19,915	$493	$20,408	$18,343	$75	$18,418

The noncontrolling interests relate to third-party ownership interests in VLP and two joint venture companies whose financial statements we consolidate due to our controlling interests.

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

Share Activity
Activity in the number of shares of common stock and treasury stock was as follows (in millions):

	Three Months Ended March 31,			
	2014		2013	
	Common Stock	Treasury Stock	Common Stock	Treasury Stock
Balance as of beginning of period	673	(138)	673	(121)
Transactions in connection with stock-based compensation plans:				
Stock issuances	—	2	—	3
Stock repurchases	—	—	—	—
Stock repurchases under buyback program	—	(4)	—	(7)
Balance as of end of period	673	(140)	673	(125)

Common Stock Dividends
On May 1, 2014, our board of directors declared a quarterly cash dividend of $0.25 per common share payable on June 18, 2014 to holders of record at the close of business on May 21, 2014.

Income Tax Effects related to Components of Other Comprehensive Income
The tax effects allocated to each component of other comprehensive income (loss) were as follows (in millions):

	Three Months Ended March 31,					
	2014			2013		
	Before-Tax Amount	Tax Expense (Benefit)	Net Amount	Before-Tax Amount	Tax Expense (Benefit)	Net Amount
Foreign currency translation adjustment	$(74)	$—	$(74)	$(204)	$—	$(204)
Pension and other postretirement benefits:						
Gain arising during the period related to plan amendments	—	—	—	328	115	213
Amounts reclassified into income related to:						
Net actuarial loss	8	3	5	14	5	9
Prior service credit	(10)	(3)	(7)	(6)	(2)	(4)
Net gain (loss) on pension and other postretirement benefits	(2)	—	(2)	336	118	218
Derivative instruments designated and qualifying as cash flow hedges:						
Net gain arising during the period	7	2	5	1	—	1
Net gain reclassified into income	(3)	(1)	(2)	(3)	(1)	(2)
Net gain (loss) on cash flow hedges	4	1	3	(2)	(1)	(1)
Other comprehensive income (loss)	$(72)	$1	$(73)	$130	$117	$13

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

Accumulated Other Comprehensive Income
Changes in accumulated other comprehensive income by component, net of tax, were as follows (in millions):

	Foreign Currency Translation Adjustment	Defined Benefit Pension Items	Gains and (Losses) on Cash Flow Hedges	Total
Balance as of December 31, 2013	$408	$(58)	$—	$350
Other comprehensive income (loss) before reclassifications	(74)	—	5	(69)
Amounts reclassified from accumulated other comprehensive income	—	(2)	(2)	(4)
Net other comprehensive income (loss)	(74)	(2)	3	(73)
Balance as of March 31, 2014	$334	$(60)	$3	$277

	Foreign Currency Translation Adjustment	Defined Benefit Pension Items	Gains and (Losses) on Cash Flow Hedges	Total
Balance as of December 31, 2012	$665	$(558)	$1	$108
Other comprehensive income (loss) before reclassifications	(204)	213	1	10
Amounts reclassified from accumulated other comprehensive income	—	5	(2)	3
Net other comprehensive income (loss)	(204)	218	(1)	13
Balance as of March 31, 2013	$461	$(340)	$—	$121

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

Amounts reclassified out of accumulated other comprehensive income (loss) and into net income were as follows (in millions):

Details about Accumulated Other Comprehensive Income Components	Three Months Ended March 31, 2014	2013	Affected Line Item in the Statement of Income
Amortization of items related to defined benefit pension plans:			
Net actuarial loss	$(8)	$(14)	(a)
Prior service credit	10	6	(a)
	2	(8)	Total before tax
	—	3	Tax benefit
	$2	$(5)	Net of tax
Gains on cash flow hedges:			
Commodity contracts	$3	$3	Cost of sales
	3	3	Total before tax
	(1)	(1)	Tax expense
	$2	$2	Net of tax
Total reclassifications for the period	$4	$(3)	Net of tax

(a) These accumulated other comprehensive income (loss) components are included in the computation of net periodic benefit cost, as further discussed in Note 7. Net periodic benefit cost is reflected in operating expenses and general and administrative expenses.

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

7. EMPLOYEE BENEFIT PLANS

The components of net periodic benefit cost related to our defined benefit plans were as follows (in millions) :

	Pension Plans		Other Postretirement Benefit Plans	
	2014	2013	2014	2013
Three months ended March 31:				
Service cost	$30	$36	$2	$3
Interest cost	23	22	4	4
Expected return on plan assets	(33)	(32)	—	—
Amortization of:				
Prior service credit	(5)	(3)	(5)	(3)
Net actuarial loss	8	14	—	—
Net periodic benefit cost	$23	$37	$1	$4

In February 2013, we announced changes to certain of our U.S. qualified pension plans that cover the majority of our U.S. employees who work in our refining segment and corporate operations. Benefits under our primary pension plan changed from a final average pay formula to a cash balance formula with staged effective dates that commence either on July 1, 2013 or January 1, 2015 depending on the age and service of the affected employees. All final average pay benefits will be frozen as of December 31, 2014, with all future benefits to be earned under the new cash balance formula. These plan amendments resulted in a $328 million decrease to pension liabilities and a related increase to other comprehensive income during the three months ended March 31, 2013. The benefit of this remeasurement will be amortized into income through 2025.

Our anticipated contributions to our pension and other postretirement benefit plans during 2014 have not changed from amounts previously disclosed in our financial statements for the year ended December 31, 2013. We contributed $10 million and $8 million, respectively, to our pension plans and $4 million and $4 million, respectively, to our other postretirement benefit plans during the three months ended March 31, 2014 and 2013.

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

8. EARNINGS PER COMMON SHARE

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

	Three Months Ended March 31,			
	2014		2013	
	Restricted Stock	Common Stock	Restricted Stock	Common Stock
Earnings per common share:				
Net income attributable to Valero stockholders		$828		$654
Less dividends paid:				
Common stock		132		110
Nonvested restricted stock		1		1
Undistributed earnings		$695		$543
Weighted-average common shares outstanding	2	531	3	550
Earnings per common share:				
Distributed earnings	$0.25	$0.25	$0.20	$0.20
Undistributed earnings	1.30	1.30	0.98	0.98
Total earnings per common share	$1.55	$1.55	$1.18	$1.18
Earnings per common share – assuming dilution:				
Net income attributable to Valero stockholders		$828		$654
Weighted-average common shares outstanding		531		550
Common equivalent shares:				
Stock options		3		4
Performance awards and nonvested restricted stock		2		2
Weighted-average common shares outstanding – assuming dilution		536		556
Earnings per common share – assuming dilution		$1.54		$1.18

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

The following table reflects potentially dilutive securities (in millions) that were excluded from the calculation of "earnings per common share – assuming dilution" as the effect of including such securities would have been antidilutive. Stock options were excluded from weighted-average common shares outstanding – assuming dilution because the exercise price of the stock option was greater than the average market price of our common shares during each reporting period.

	Three Months Ended March 31,	
	2014	2013
Stock options	1	3

9. SEGMENT INFORMATION

In May 2013, we completed the separation of our retail business, creating an independent public company named CST Brands, Inc. (CST), and as a result, we no longer operate a retail business or report retail segment operating results. Segment activity related to our retail business prior to the separation is reflected in the retail segment results below. Motor fuel sales to CST (our former retail business), which were eliminated in consolidation prior to the separation, are reported as refining segment operating revenues from external customers after May 1, 2013.

The following table reflects activity related to our reportable segments (in millions):

	Refining	Ethanol	Retail	Corporate	Total
Three months ended March 31, 2014:					
Operating revenues from external customers	$32,452	$1,211	$—	$—	$33,663
Intersegment revenues	—	25	—	—	25
Operating income (loss)	1,279	243	—	(172)	1,350
Three months ended March 31, 2013:					
Operating revenues from external customers	29,553	1,004	2,917	—	33,474
Intersegment revenues	2,205	55	—	—	2,260
Operating income (loss)	1,212	14	42	(207)	1,061

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CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

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

	March 31, 2014	December 31, 2013
Refining	$41,235	$40,834
Ethanol	1,003	889
Corporate	4,861	5,537
Total assets	$47,099	$47,260

In March 2014, we purchased an idled corn ethanol plant in Mount Vernon, Indiana for $34 million from a wholly owned subsidiary of Aventine Renewable Energy Holdings, Inc. We expect to resume production during the third quarter of 2014. We will finalize our purchase accounting once a determination of the fair values of the assets acquired and liabilities assumed is available, pending the completion of independent appraisals and other evaluations.

10. SUPPLEMENTAL CASH FLOW INFORMATION

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

	Three Months Ended March 31, 2014	2013
Decrease (increase) in current assets:		
Receivables, net	$958	$409
Inventories	(1,356)	(1,074)
Income taxes receivable	(31)	79
Prepaid expenses and other	—	(233)
Increase (decrease) in current liabilities:		
Accounts payable	(299)	561
Accrued expenses	(50)	181
Taxes other than income taxes	(198)	318
Income taxes payable	(112)	14
Changes in current assets and current liabilities	$(1,088)	$255

The above changes in current assets and current liabilities differ from changes between amounts reflected in the applicable 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 debt and capital lease obligations;
- amounts accrued for capital expenditures and deferred turnaround and catalyst costs are reflected in investing activities when such amounts are paid;

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

- amounts accrued for common stock purchases in the open market that are not settled as of the balance sheet date are reflected in financing activities when the purchases are settled and paid; and
- certain differences between balance sheet changes and the changes reflected above result from translating foreign currency denominated balances at the applicable exchange rates as of each balance sheet date.

There were no significant noncash investing or financing activities for the three months ended March 31, 2014 and 2013.

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

	Three Months Ended March 31,	
	2014	2013
Interest paid in excess of amount capitalized	$74	$56
Income taxes paid, net	459	48

11. FAIR VALUE MEASUREMENTS

General

GAAP requires that certain assets and liabilities be measured at fair value on a recurring or nonrecurring basis in our balance sheets, which are presented below under “Recurring Fair Value Measurements” and “Nonrecurring Fair Value Measurements.” Recurring fair value measurements of assets or liabilities are those that GAAP requires or permits in the balance sheet at the end of each reporting period, such as derivative financial instruments. Nonrecurring fair value measurements of assets or liabilities are those that GAAP requires or permits in the balance sheet in particular circumstances, such as the impairment of property, plant and equipment.

GAAP also requires the disclosure of the fair values of financial instruments when an option to elect fair value accounting has been provided, but such election has not been made. A debt obligation is an example of such a financial instrument. The disclosure of the fair values of financial instruments not recognized at fair value in our balance sheet is presented below under “Other Financial Instruments.”

GAAP provides a framework for measuring fair value and establishes a three-level fair value hierarchy that prioritizes inputs to valuation techniques based on the degree to which objective prices in external active markets are available to measure fair value. Following is a description of each of the levels of the fair value hierarchy.

- Level 1 - Observable inputs, such as unadjusted quoted prices in active markets for identical assets or liabilities.
- Level 2 - Inputs other than quoted prices included within Level 1 that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.
- Level 3 - Unobservable inputs for the asset or liability. Unobservable inputs reflect our own assumptions about what market participants would use to price the asset or liability. The inputs are

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

developed based on the best information available in the circumstances, which might include occasional market quotes or sales of similar instruments or our own financial data such as internally developed pricing models, discounted cash flow methodologies, as well as instruments for which the fair value determination requires significant judgment.

Recurring Fair Value Measurements
The tables below present information (in millions) about our assets and liabilities recognized at their fair values in our balance sheets categorized according to the fair value hierarchy of the inputs utilized by us to determine the fair values as of March 31, 2014 and December 31, 2013.

We have elected to offset the fair value amounts recognized for multiple similar derivative contracts executed with the same counterparty, including any related cash collateral assets or obligations as shown below; however, fair value amounts by hierarchy level are presented on a gross basis in the tables below. We have no derivative contracts that are subject to master netting arrangements that are reflected gross on the balance sheet.

	March 31, 2014							
	Fair Value Hierarchy			Total Gross Fair Value	Effect of Counter-party Netting	Effect of Cash Collateral Netting	Net Carrying Value on Balance Sheet	Cash Collateral Paid or Received Not Offset
	Level 1	Level 2	Level 3					
Assets:								
Commodity derivative contracts	$709	$163	$—	$872	$(759)	$(24)	$89	$—
Physical purchase contracts	—	2	—	2	n/a	n/a	2	n/a
Investments of certain benefit plans	99	—	11	110	n/a	n/a	110	n/a
Total	$808	$165	$11	$984	$(759)	$(24)	$201	
Liabilities:								
Commodity derivative contracts	$643	$149	$—	$792	$(759)	$(31)	$2	$(66)
Biofuels blending obligation	—	75	—	75	n/a	n/a	75	n/a
Physical purchase contracts	—	1	—	1	n/a	n/a	1	n/a
Foreign currency contracts	9	—	—	9	n/a	n/a	9	n/a
Total	$652	$225	$—	$877	$(759)	$(31)	$87	

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

	December 31, 2013							
	Fair Value Hierarchy			Total Gross Fair Value	Effect of Counter-party Netting	Effect of Cash Collateral Netting	Net Carrying Value on Balance Sheet	Cash Collateral Paid or Received Not Offset
	Level 1	Level 2	Level 3					
Assets:								
Commodity derivative contracts	$499	$38	$—	$537	$(505)	$(7)	$25	$—
Investments of certain benefit plans	98	—	11	109	n/a	n/a	109	n/a
Total	$597	$38	$11	$646	$(505)	$(7)	$134	
Liabilities:								
Commodity derivative contracts	$492	$24	$—	$516	$(505)	$(6)	$5	$(76)
Biofuels blending obligation	—	11	—	11	n/a	n/a	11	n/a
Physical purchase contracts	—	5	—	5	n/a	n/a	5	n/a
Foreign currency contracts	8	—	—	8	n/a	n/a	8	n/a
Total	$500	$40	$—	$540	$(505)	$(6)	$29	

A description of our assets and liabilities recognized at fair value along with the valuation methods and inputs we used to develop their fair value measurements are as follows:

- Commodity derivative contracts consist primarily of exchange-traded futures and swaps, and as disclosed in Note 12, some of these contracts are designated as hedging instruments. These contracts are measured at fair value using the market approach. Exchange-traded futures are valued based on quoted prices from the exchange and are categorized in Level 1 of the fair value hierarchy. Swaps are priced using third-party broker quotes, industry pricing services, and exchange-traded curves, with appropriate consideration of counterparty credit risk, but because they have contractual terms that are not identical to exchange-traded futures instruments with a comparable market price, these financial instruments are categorized in Level 2 of the fair value hierarchy.
- Physical purchase contracts represent the fair value of firm commitments to purchase crude oil feedstocks and the fair value of fixed-price corn purchase contracts, and as disclosed in Note 12, some of these contracts are designated as hedging instruments. The fair values of these firm commitments and purchase contracts are measured using a market approach based on quoted prices from the commodity exchange or an independent pricing service and are categorized in Level 2 of the fair value hierarchy.
- Investments of certain benefit plans consist of investment securities held by trusts for the purpose of satisfying a portion of our obligations under certain U.S. nonqualified benefit plans. The assets categorized in Level 1 of the fair value hierarchy are measured at fair value using a market approach based on quoted prices from national securities exchanges. The assets categorized in Level 3 of the fair value hierarchy represent insurance contracts, the fair value of which is provided by the insurer.

- Foreign currency contracts consist of foreign currency exchange and purchase contracts entered into by our international operations to manage our exposure to exchange rate fluctuations on transactions

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

denominated in currencies other than the local (functional) currencies of those operations. These contracts are valued based on quoted prices from the exchange and are categorized in Level 1 of the fair value hierarchy.

- Our biofuels blending obligation represents a liability for the purchase of biofuel credits (primarily Renewable Identification Numbers (RINs) in the U.S.) needed to satisfy our obligation to blend biofuels into the products we produce. To the degree we are unable to blend at percentages required under various governmental and regulatory programs, we must purchase biofuel credits to comply with these programs. These programs are further described in Note 12 under "Compliance Program Price Risk." This liability is based on our deficit in biofuel credits as of the balance sheet date, if any, after considering any biofuel credits acquired or under contract, and is equal to the product of the biofuel credits deficit and the market price of these credits as of the balance sheet date. This liability is categorized in Level 2 of the fair value hierarchy and is measured at fair value using the market approach based on quoted prices from an independent pricing service.

There were no transfers between Level 1 and Level 2 for assets and liabilities held as of March 31, 2014 and December 31, 2013 that were measured at fair value on a recurring basis.

There was no activity during the three months ended March 31, 2014 and 2013 related to the fair value amounts categorized in Level 3 as of March 31, 2014 and December 31, 2013.

Nonrecurring Fair Value Measurements

There were no assets or liabilities that were measured at fair value on a nonrecurring basis as of March 31, 2014 and December 31, 2013.

Other Financial Instruments

Financial instruments that we recognize in our balance sheets at their carrying amounts are shown in the table below (in millions):

	March 31, 2014		December 31, 2013	
	Carrying Amount	Fair Value	Carrying Amount	Fair Value
Financial assets:				
Cash and temporary cash investments	$3,647	$3,647	$4,292	$4,292
Financial liabilities:				
Debt (excluding capital leases)	6,526	7,883	6,525	7,659

The methods and significant assumptions used to estimate the fair value of these financial instruments are as follows:

- The fair value of cash and temporary cash investments approximates the carrying value due to the low level of credit risk of these assets combined with their short maturities and market interest rates (Level 1).
- The fair value of debt is determined primarily using the market approach based on quoted prices provided by third-party brokers and vendor pricing services (Level 2).

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

12. PRICE RISK MANAGEMENT ACTIVITIES

We are exposed to market risks related to the volatility in the price of commodities, interest rates, and foreign currency exchange rates. We enter into derivative instruments to manage some of these risks, including derivative instruments related to the various commodities we purchase or produce, interest rate swaps, and foreign currency exchange and purchase contracts, as described below under "Risk Management Activities by Type of Risk." These derivative instruments are recorded as either assets or liabilities measured at their fair values (see Note 11), as summarized below under "Fair Values of Derivative Instruments." In addition, the effect of these derivative instruments on our income is summarized below under "Effect of Derivative Instruments on Income and Other Comprehensive Income."

When we enter into a derivative instrument, it is designated as a fair value hedge, a cash flow hedge, an economic hedge, or a trading derivative. The gain or loss on a derivative instrument designated and qualifying as a fair value hedge, as well as the offsetting loss or gain on the hedged item attributable to the hedged risk, is recognized currently in income in the same period. The effective portion of the gain or loss on a derivative instrument designated and qualifying as a cash flow hedge is initially reported as a component of other comprehensive income and is then recorded into income in the period or periods during which the hedged forecasted transaction affects income. The ineffective portion of the gain or loss on the cash flow derivative instrument, if any, is recognized in income as incurred. For our economic hedges (derivative instruments not designated as fair value or cash flow hedges) and for derivative instruments entered into by us for trading purposes, the derivative instrument is recorded at fair value and changes in the fair value of the derivative instrument are recognized currently in income. The cash flow effects of all of our derivative instruments are reflected in operating activities in our statements of cash flows for all periods presented.

We are also exposed to market risk related to the volatility in the price of credits needed to comply with various governmental and regulatory programs. To manage this risk, we enter into contracts to purchase these credits when prices are deemed favorable. Some of these contracts are derivative instruments; however, we elect the normal purchase exception and do not record these contracts at their fair values.

Risk Management Activities by Type of Risk
Commodity Price Risk
We are exposed to market risks related to the volatility in the price of crude oil, refined products (primarily gasoline and distillate), grain (primarily corn), soybean oil, and natural gas used in our operations. To reduce the impact of price volatility on our results of operations and cash flows, we use commodity derivative instruments, including futures, swaps, and options. We use the futures markets for the available liquidity, which provides greater flexibility in transacting our hedging and trading operations. We use swaps primarily to manage our price exposure. Our positions in commodity derivative instruments are monitored and managed on a daily basis by a risk control group to ensure compliance with our stated risk management policy that has been approved by our board of directors.

For risk management purposes, we use fair value hedges, cash flow hedges, and economic hedges. In addition to the use of derivative instruments to manage commodity price risk, we also enter into certain commodity derivative instruments for trading purposes. Our objective for entering into each type of hedge or trading derivative is described below.

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

- Fair Value Hedges – Fair value hedges are used to hedge price volatility in certain refining inventories and firm commitments to purchase inventories. The level of activity for our fair value hedges is based on the level of our operating inventories, and generally represents the amount by which our inventories differ from our previous year-end LIFO inventory levels.

As of March 31, 2014, we had the following outstanding commodity derivative instruments that were entered into to hedge crude oil and refined product inventories and commodity derivative instruments related to the physical purchase of crude oil and refined products at a fixed price. The information presents the notional volume of outstanding contracts by type of instrument and year of maturity (volumes in thousands of barrels).

Derivative Instrument	Notional Contract Volumes by Year of Maturity 2014
Crude oil and refined products:	
Futures – long	2,229
Futures – short	2,905
Physical contracts – long	676

- Cash Flow Hedges – Cash flow hedges are used to hedge price volatility in certain forecasted feedstock and refined product purchases, refined product sales, and natural gas purchases. The objective of our cash flow hedges is to lock in the price of forecasted feedstock, refined product, or natural gas purchases or refined product sales at existing market prices that we deem favorable.

As of March 31, 2014, we had the following outstanding commodity derivative instruments that were entered into to hedge forecasted purchases or sales of crude oil and refined products. The information presents the notional volume of outstanding contracts by type of instrument and year of maturity (volumes in thousands of barrels).

Derivative Instrument	Notional Contract Volumes by Year of Maturity 2014
Crude oil and refined products:	
Futures – long	13,578
Futures – short	10,312
Physical contracts – short	3,266

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

- Economic Hedges – Economic hedges represent commodity derivative instruments that are not designated as fair value or cash flow hedges and are used to manage price volatility in certain (i) refinery feedstock, refined product, animal fat feedstock, and corn inventories, (ii) forecasted refinery feedstock, refined product, and corn purchases, and refined product sales, and (iii) fixed-price corn purchase contracts. Our objective for entering into economic hedges is consistent with the objectives discussed above for fair value hedges and cash flow hedges. However, the economic hedges are not designated as a fair value hedge or a cash flow hedge for accounting purposes, usually due to the difficulty of establishing the required documentation at the date that the derivative instrument is entered into that would allow us to achieve "hedge deferral accounting."

As of March 31, 2014, we had the following outstanding commodity derivative instruments that were used as economic hedges and commodity derivative instruments related to the physical purchase of corn at a fixed price. The information presents the notional volume of outstanding contracts by type of instrument and year of maturity (volumes in thousands of barrels, except those identified as corn contracts that are presented in thousands of bushels, and soybean oil contracts that are presented in thousands of pounds).

	Notional Contract Volumes by Year of Maturity	
Derivative Instrument	2014	2015
Crude oil and refined products:		
Swaps – long	10,260	—
Swaps – short	10,551	—
Futures – long	68,833	14
Futures – short	95,621	—
Corn:		
Futures – long	12,085	—
Futures – short	32,130	2,075
Physical contracts – long	16,957	2,157
Soybean oil:		
Futures – short	99,540	—

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

- Trading Derivatives – Our objective for entering into commodity derivative instruments for trading purposes is to take advantage of existing market conditions related to future results of operations and cash flows.

As of March 31, 2014, we had the following outstanding commodity derivative instruments that were entered into for trading purposes. The information presents the notional volume of outstanding contracts by type of instrument and year of maturity (volumes represent thousands of barrels, except those identified as natural gas contracts that are presented in billions of British thermal units and corn contracts that are presented in thousands of bushels).

	Notional Contract Volumes by Year of Maturity	
Derivative Instrument	2014	2015
Crude oil and refined products:		
Swaps – long	17,760	—
Swaps – short	17,760	—
Futures – long	97,715	8,940
Futures – short	97,631	8,940
Options – long	12,700	—
Options – short	13,150	—
Natural gas:		
Futures – long	1,000	1,500
Futures – short	750	—
Options – long	500	—
Corn:		
Futures – long	145	—
Futures – short	145	—

Interest Rate Risk
Our primary market risk exposure for changes in interest rates relates to our debt obligations. We manage our exposure to changing interest rates through the use of a combination of fixed-rate and floating-rate debt. In addition, at times we have used interest rate swap agreements to manage our fixed to floating interest rate position by converting certain fixed-rate debt to floating-rate debt. We had no interest rate derivative instruments outstanding as of March 31, 2014 or December 31, 2013, or during the three months ended March 31, 2014 and 2013.

Foreign Currency Risk
We are exposed to exchange rate fluctuations on transactions entered into by our international operations that are denominated in currencies other than the local (functional) currencies of those operations. To manage our exposure to these exchange rate fluctuations, we use foreign currency exchange and purchase contracts. These contracts are not designated as hedging instruments for accounting purposes, and therefore they are classified as economic hedges. As of March 31, 2014, we had commitments to purchase $999 million of

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

U.S. dollars. The majority of these commitments matured on or before April 30, 2014, resulting in an immaterial loss in the second quarter of 2014.

Compliance Program Price Risk
We are exposed to market risk related to the volatility in the price of credits needed to comply with various governmental and regulatory programs. The most significant programs impacting our operations are those that require us to blend biofuels into the products we produce, and we are subject to such programs in most of the countries in which we operate. These countries set annual quotas for the percentage of biofuels that must be blended into the motor fuels consumed in these countries. As a producer of motor fuels from petroleum, we are obligated to blend biofuels into the products we produce at a rate that is at least equal to the applicable quota. To the degree we are unable to blend at the applicable rate, we must purchase biofuel credits (primarily RINs in the U.S.). We are exposed to the volatility in the market price of these credits, and we manage that risk by purchasing biofuel credits when prices are deemed favorable. The cost of meeting our obligations under these compliance programs was $92 million and $130 million for the three months ended March 31, 2014 and 2013, respectively. These amounts are reflected in cost of sales.

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

Fair Values of Derivative Instruments

The following tables provide information about the fair values of our derivative instruments as of March 31, 2014 and December 31, 2013 (in millions) and the line items in the balance sheets in which the fair values are reflected. See Note 11 for additional information related to the fair values of our derivative instruments.

As indicated in Note 11, we net fair value amounts recognized for multiple similar derivative contracts executed with the same counterparty under master netting arrangements, including cash collateral assets and obligations. The tables below, however, are presented on a gross asset and gross liability basis, which results in the reflection of certain assets in liability accounts and certain liabilities in asset accounts.

	Balance Sheet Location	March 31, 2014	
		Asset Derivatives	Liability Derivatives
Derivatives designated as hedging instruments			
Commodity contracts:			
Futures	Receivables, net	$19	$23
Derivatives not designated as hedging instruments			
Commodity contracts:			
Futures	Receivables, net	$690	$620
Swaps	Receivables, net	159	142
Swaps	Accrued expenses	3	5
Options	Receivables, net	1	2
Physical purchase contracts	Inventories	2	1
Foreign currency contracts	Accrued expenses	—	9
Total		$855	$779
Total derivatives		$874	$802

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

	Balance Sheet Location	December 31, 2013	
		Asset Derivatives	Liability Derivatives
Derivatives designated as hedging instruments			
Commodity contracts:			
Futures	Receivables, net	$25	$36
Derivatives not designated as hedging instruments			
Commodity contracts:			
Futures	Receivables, net	$474	$455
Swaps	Receivables, net	33	18
Swaps	Prepaid expenses and other	3	—
Swaps	Accrued expenses	—	5
Options	Receivables, net	2	2
Physical purchase contracts	Inventories	—	5
Foreign currency contracts	Accrued expenses	—	8
Total		$512	$493
Total derivatives		$537	$529

Market and Counterparty Risk

Our price risk management activities involve the receipt or payment of fixed price commitments into the future. These transactions give rise to market risk, which is the risk that future changes in market conditions may make an instrument less valuable. We closely monitor and manage our exposure to market risk on a daily basis in accordance with policies approved by our board of directors. Market risks are monitored by a risk control group to ensure compliance with our stated risk management policy. Concentrations of customers in the refining industry may impact our overall exposure to counterparty risk because these customers may be similarly affected by changes in economic or other conditions. In addition, financial services companies are the counterparties in certain of our price risk management activities, and such financial services companies may be adversely affected by periods of uncertainty and illiquidity in the credit and capital markets.

There were no material amounts due from counterparties in the refining or financial services industry as of March 31, 2014 or December 31, 2013. We do not require any collateral or other security to support derivative instruments into which we enter. We also do not have any derivative instruments that require us to maintain a minimum investment-grade credit rating.

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

Effect of Derivative Instruments on Income and Other Comprehensive Income
The following tables provide information about the gain or loss recognized in income and other comprehensive income on our derivative instruments and the line items in the financial statements in which such gains and losses are reflected (in millions).

Derivatives in Fair Value Hedging Relationships	Location of Gain (Loss) Recognized in Income on Derivatives	Three Months Ended March 31, 2014	2013
Commodity contracts:			
Loss recognized in income on derivatives	Cost of sales	$(31)	$(1)
Gain recognized in income on hedged item	Cost of sales	30	—
Loss recognized in income on derivatives (ineffective portion)	Cost of sales	(1)	(1)

For fair value hedges, no component of the derivative instruments' gains or losses was excluded from the assessment of hedge effectiveness for the three months ended March 31, 2014 and 2013. There were no amounts recognized in income for hedged firm commitments that no longer qualified as fair value hedges during the three months ended March 31, 2014 and 2013.

Derivatives in Cash Flow Hedging Relationships	Location of Gain (Loss) Recognized in Income on Derivatives	Three Months Ended March 31, 2014	2013
Commodity contracts:			
Gain recognized in OCI on derivatives (effective portion)		$7	$1
Gain reclassified from accumulated OCI into income (effective portion)	Cost of sales	3	3
Loss recognized in income on derivatives (ineffective portion)	Cost of sales	(4)	(1)

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

For cash flow hedges, no component of the derivative instruments' gains or losses was excluded from the assessment of hedge effectiveness for the three months ended March 31, 2014 and 2013. For the three months ended March 31, 2014, cash flow hedges primarily related to forward purchases of crude oil, with $3 million of cumulative after-tax gains on cash flow hedges remaining in accumulated other comprehensive income. We estimate that this deferred gain will be reclassified into cost of sales over the next 12 months as a result of hedged transactions that are forecasted to occur. For the three months ended March 31, 2014 and 2013, there were no amounts reclassified from accumulated other comprehensive income into income as a result of the discontinuance of cash flow hedge accounting.

Derivatives Designated as Economic Hedges and Other Derivative Instruments	Location of Gain Recognized in Income on Derivatives	Three Months Ended March 31, 2014	2013
Commodity contracts	Cost of sales	$4	$35
Foreign currency contracts	Cost of sales	9	25
Total		$13	$60

Trading Derivatives	Location of Gain (Loss) Recognized in Income on Derivatives	Three Months Ended March 31, 2014	2013
Commodity contracts	Cost of sales	$(1)	$2
RINs fixed-price contracts	Cost of sales	—	(13)
Total		$(1)	$(11)

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

CAUTIONARY STATEMENT FOR THE PURPOSE OF SAFE HARBOR PROVISIONS OF THE PRIVATE SECURITIES LITIGATION REFORM ACT OF 1995

This Form 10-Q, including without limitation our discussion below under the heading "OVERVIEW AND 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," " "target," "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 ethanol 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 globally and in the regions where we operate;
- expectations regarding environmental, tax, and other regulatory initiatives; and
- the effect of general economic and other conditions on refining and ethanol 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 produce crude oil or consume refined products;
- demand for, and supplies of, refined products such as gasoline, diesel fuel, jet fuel, petrochemicals, and ethanol;
- demand for, and supplies of, crude oil and other feedstocks;
- the ability of the members of the Organization of Petroleum Exporting Countries to agree on and to maintain crude oil price and production controls;
- the level of consumer demand, including seasonal fluctuations;
- refinery overcapacity or undercapacity;
- our ability to successfully integrate any acquired businesses into our operations;
- the actions taken by competitors, including both pricing and adjustments to refining capacity in response to market conditions;
- the level of competitors' imports into markets that we supply;
- accidents, unscheduled shutdowns, or other catastrophes affecting our refineries, machinery, pipelines, equipment, and information systems, or those of our suppliers or customers;

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- 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;
- the levels of government subsidies for ethanol and other alternative fuels;
- 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, grain and other feedstocks, and refined products and ethanol;
- 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 legislation or rulemakings by governmental authorities, including tax and environmental regulations, such as those to be implemented under the California Global Warming Solutions Act (also known as AB 32) and the United States (U.S.) Environmental Protection Agency's (EPA) regulation of greenhouse gases, 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, the pound sterling, and the euro relative to the U.S. dollar; and
- overall economic conditions, including the stability and liquidity of financial markets.

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 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 AND OUTLOOK

Overview

For the first quarter of 2014, we reported net income attributable to Valero stockholders of $828 million, or $1.54 per share (assuming dilution), compared to $654 million, or $1.18 per share (assuming dilution), for the first quarter of 2013.

The increase in net income attributable to Valero stockholders of $174 million was primarily due to the increase of $289 million in our operating income as outlined by business segment in the table below (in millions).

	Three Months Ended March 31,		
	2014	2013	Change
Operating income (loss) by business segment:			
Refining	$1,279	$1,212	$67
Retail	—	42	(42)
Ethanol	243	14	229
Corporate	(172)	(207)	35
Total	$1,350	$1,061	$289

The $67 million increase in refining segment operating income in the first quarter of 2014 compared to the first quarter of 2013 was primarily due to higher refining throughput margin per barrel and higher throughput volumes in most of our regions, partially offset by higher energy costs and higher depreciation expense between the periods.

On May 1, 2013, we completed the separation of our retail business, creating an independent public company named CST Brands, Inc. (CST), and as a result, we no longer operate a retail business. Therefore, we did not have any retail segment operating results for the first quarter of 2014, resulting in the $42 million decrease in retail segment operating income in the first quarter of 2014 compared to the first quarter of 2013.

Our ethanol segment operating income increased $229 million in the first quarter of 2014 compared to the first quarter of 2013 due to higher gross margin per gallon and higher production volumes. Significantly lower corn prices combined with higher ethanol prices quarter over quarter contributed to the increase in gross margin per gallon. Production volumes increased between the quarters in response to the improved ethanol gross margin per gallon.

Additional analysis of the changes in the operating income of our business segments and other components of net income attributable to Valero stockholders is provided below under “RESULTS OF OPERATIONS.”

Outlook

Our refining segment benefits from processing sour crude oils (such as Mars and Maya crude oil) and light sweet crude oils (such as West Texas Intermediate and Louisiana Light Sweet crude oil) due to the favorable discounts between the prices of these types of crude oil and the price of Brent crude oil. Because the market for refined products generally tracks the price of Brent crude oil, which is a benchmark sweet crude oil, we benefit when we process crude oils that are priced at a discount to Brent crude oil. The discounts in the prices of certain light sweet crude oils and sour crude oils compared to the price of Brent crude oil in the first quarter of 2014 widened compared to the first quarter of 2013, which positively impacted our refining margins. Thus far in the second quarter of 2014, discounts on crude oils have shown mixed results compared to the first quarter of 2014 as some crude oil discounts have widened while others have narrowed, and we expect these discounts to remain volatile. Gasoline margins, which were seasonally weak during the first quarter of 2014, have increased in the second quarter and look positive as the summer driving season

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approaches. Energy markets and margins are volatile, and we expect them to continue to be volatile in the near to mid-term.

Thus far in the second quarter of 2014, ethanol margins have narrowed substantially. This is primarily due to lower ethanol prices as the weather-related transportation issues that limited supplies and production in the first quarter of 2014 are being resolved. We expect lower average ethanol margins for the remainder of 2014 as compared to the first quarter of 2014.

RESULTS OF OPERATIONS

The following tables highlight our results of operations, our operating performance, and market prices that directly impact our operations. The narrative following these tables provides an analysis of our results of operations.

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

	Three Months Ended March 31,		
	2014	2013	Change
Operating revenues	$33,663	$33,474	$189
Costs and expenses:			
Cost of sales	30,630	30,685	(55)
Operating expenses:			
Refining	973	876	97
Retail	—	169	(169)
Ethanol	129	77	52
General and administrative expenses	160	176	(16)
Depreciation and amortization expense:			
Refining	397	358	39
Retail	—	30	(30)
Ethanol	12	11	1
Corporate	12	31	(19)
Total costs and expenses	32,313	32,413	(100)
Operating income	1,350	1,061	289
Other income, net	15	14	1
Interest and debt expense, net of capitalized interest	(100)	(83)	(17)
Income before income tax expense	1,265	992	273
Income tax expense	429	340	89
Net income	836	652	184
Less: Net income (loss) attributable to noncontrolling interests	8	(2)	10
Net income attributable to Valero stockholders	$828	$654	$174
Earnings per common share – assuming dilution	$1.54	$1.18	$0.36

See note references on page 38.

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

	Three Months Ended March 31,		
	2014	2013	Change
Refining:			