VALERO L P
Form 10-Q
May 10, 2006
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

(Mark One)

x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended March 31, 2006

OR

¨ TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the transition period from ______ to ______

Commission File Number 1-16417

VALERO L.P.

(Exact name of registrant as specified in its charter)

Delaware	**74-2956831**
(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)

Telephone number: (210) 345-2000

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. **Yes x No ¨**

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

Large accelerated filer **x** Accelerated filer ¨ Non-accelerated filer ¨

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

The number of common units outstanding as of May 8, 2006 was 46,809,749.

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PART I FINANCIAL INFORMATION

Item 1. Financial Statements

VALERO L.P. AND SUBSIDIARIES

CONSOLIDATED BALANCE SHEETS

(Thousands of Dollars, Except Unit Data)

	March 31, 2006 (Unaudited)	December 31, 2005
Assets		
Current assets:		
Cash and cash equivalents	$ 105,433	$ 36,054
Receivable from Valero Energy	19,780	21,873
Accounts receivable, net of allowance for doubtful accounts of $1,809 and $1,976 as of March 31, 2006 and December 31, 2005, respectively	80,771	110,066
Inventories	14,607	17,473
Other current assets	30,638	30,138
Assets of businesses held for sale		79,807
Total current assets	251,229	295,411
Property and equipment, at cost	2,436,299	2,417,529
Accumulated depreciation and amortization	(279,747)	(257,316)
Property and equipment, net	2,156,552	2,160,213
Intangible assets, net	58,427	59,159
Goodwill	771,486	767,587
Investment in joint ventures	73,794	73,986
Deferred charges and other assets, net	11,692	10,636
Total assets	$ 3,323,180	$ 3,366,992
Liabilities and Partners Equity		
Current liabilities:		
Current portion of long-term debt	$ 566	$ 1,046
Payable to Valero Energy	9,223	12,800
Accounts payable	73,367	104,320
Accrued interest payable	9,712	16,391
Accrued liabilities	39,567	46,917
Taxes other than income taxes	8,383	9,013
Income taxes payable	3,923	4,001
Liabilities of businesses held for sale		11,100
Total current liabilities	144,741	205,588
Long-term debt, less current portion	1,187,662	1,169,659
Long-term payable to Valero Energy	5,851	5,507
Deferred income taxes	9,477	13,576
Other long-term liabilities	76,969	71,883

Commitments and contingencies (Note 5)		
Partners equity:		
Common units (37,210,427 outstanding as of March 31, 2006 and December 31, 2005)	1,745,214	1,749,007
Subordinated units (9,599,322 outstanding as of March 31, 2006 and December 31, 2005)	113,149	114,127
General partner s equity	39,184	38,913
Accumulated other comprehensive income (loss)	933	(1,268)
Total partners equity	1,898,480	1,900,779
Total liabilities and partners equity	$ 3,323,180	$ 3,366,992

See Condensed Notes to Consolidated Financial Statements.

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VALERO L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF INCOME

(Unaudited, Thousands of Dollars, Except Unit and Per Unit Data)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Revenues:		
Services revenues:		
Third parties	$ 87,258	$ 1,294
Valero Energy	60,671	55,341
Total services revenues	147,929	56,635
Product sales	126,075	
Total revenues	274,004	56,635
Costs and expenses:		
Cost of product sales	114,218	
Operating expenses:		
Third parties	50,613	11,644
Valero Energy	20,457	8,041
Total operating expenses	71,070	19,685
General and administrative expenses:		
Third parties	2,860	746
Valero Energy	5,700	2,757
Total general and administrative expenses	8,560	3,503
Depreciation and amortization expense	24,189	8,732
Total costs and expenses	218,037	31,920
Operating income	55,967	24,715
Equity earnings in joint ventures Pipeline Company	1,206	378
Interest and other expenses, net	(15,465)	(5,829)
Income from continuing operations before income tax expense	41,708	19,264
Income tax expense	2,119	
Income from continuing operations	39,589	19,264
Loss from discontinued operations	(138)	
Net income	39,451	19,264
Less general partner s interest and incentive distributions	(4,199)	(1,476)
Limited partners interest in net income	$ 35,252	$ 17,788
Weighted-average units outstanding	46,809,749	23,041,394

Net income per unit applicable to limited partners:				
Continuing operations	$	0.75	$	0.77
Discontinued operations				
Net income	$	0.75	$	0.77
Cash distributions per unit applicable to limited partners	$	0.885	$	0.800

See Condensed Notes to Consolidated Financial Statements.

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VALERO L.P. AND SUBSIDIARIES

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, Thousands of Dollars)

	Three Months Ended March 31, 2006	Three Months Ended March 31, 2005
Cash Flows from Operating Activities:		
Net income	$ 39,451	$ 19,264
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	24,189	8,732
Equity income from joint ventures	(1,293)	(378)
Distributions from joint ventures	1,278	
Changes in operating assets and liabilities:		
Decrease in receivable from Valero Energy	2,093	250
Decrease in accounts receivable	31,738	1,280
Decrease in inventories	2,870	
Increase in other current assets	(3,412)	(872)
Decrease in payable to Valero Energy	(3,577)	(828)
Decrease in accrued interest payable	(6,679)	(5,485)
Decrease in accounts payable and other accrued liabilities	(27,314)	(4,385)
Decrease in taxes other than income taxes	(295)	(2,393)
Other, net	(1,997)	115
Net cash provided by operating activities	57,052	15,300
Cash Flows from Investing Activities:		
Reliability capital expenditures	(6,164)	(1,425)
Expansion capital expenditures	(9,428)	(2,860)
Pre-acquisition costs Kaneb		(1,954)
Other acquisition	(12,827)	
Investment in other noncurrent assets	(1,512)	
Proceeds from sale of Australia and New Zealand subsidiaries	68,628	
Distributions in excess of equity income from joint ventures	246	
Other	992	
Net cash provided by (used in) investing activities	39,935	(6,239)
Cash Flows from Financing Activities:		
Long-term borrowings	34,000	4,000
Long-term debt repayments	(11,480)	(466)
Decrease in cash book overdrafts	(4,273)	
Distributions to unitholders and general partner	(43,950)	(19,944)
Net cash used in financing activities	(25,703)	(16,410)
Effect of foreign exchange rate changes on cash	(1,905)	
Net increase (decrease) in cash and cash equivalents	69,379	(7,349)
Cash and cash equivalents at the beginning of the period	36,054	16,147
Cash and cash equivalents at the end of the period	$ 105,433	$ 8,798

Supplemental cash flow information:		
Cash paid during the period for interest	$ 25,179	$ 11,546
Cash paid during the period for income taxes	$ 1,839	$

See Condensed Notes to Consolidated Financial Statements.

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VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION, OPERATIONS AND ACCOUNTING PRONOUNCEMENTS

Organization and Operations

Valero L.P. is a publicly traded Delaware limited partnership formed in 1999 that completed its initial public offering of common units on April 16, 2001.

As used in this report, references to we, us, our or the Partnership collectively refer, depending on the context, to Valero L.P. or a wholly owned subsidiary of Valero L.P.

These unaudited consolidated financial statements include the accounts of the Partnership and subsidiaries in which the Partnership has a controlling interest. Intercompany balances and transactions have been eliminated in consolidation. Investments in 50% or less owned entities are accounted for using the equity method of accounting. Certain previously reported amounts in the 2005 consolidated financial statements have been reclassified to conform to the 2006 presentation.

These unaudited consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and notes required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal recurring nature unless disclosed otherwise. Financial information for the three months ended March 31, 2006 and 2005 included in these Condensed Notes to Consolidated Financial Statements is derived from our unaudited consolidated financial statements. Operating results for the three months ended March 31, 2006 are not necessarily indicative of the results that may be expected for the year ending December 31, 2006.

The consolidated balance sheet as of December 31, 2005 has been derived from the audited consolidated financial statements as of that date. You should read these consolidated financial statements in conjunction with the consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2005.

Our operations are managed by Valero GP, LLC. Valero GP, LLC is the general partner of Riverwalk Logistics, L.P., which is the 2% general partner of Valero L.P. Valero GP, LLC and Riverwalk Logistics, L.P. are indirect wholly owned subsidiaries of Valero Energy Corporation (Valero Energy). Valero Energy, through various affiliates, is also a limited partner in us, resulting in a combined partnership ownership of 23.4%. The remaining 76.6% limited partnership interests are held by public unitholders.

On January 15, 2006, UDS Logistics, LLC, an indirect, wholly owned subsidiary of Valero Energy, changed its name to Valero GP Holdings, LLC (Holdings). On January 25, 2006, Holdings formed Riverwalk Holdings, LLC, a Delaware limited liability company and a direct, wholly owned subsidiary, and contributed its 21.4% limited partnership interest (both common and subordinated units) in Valero L.P. and its 99.9% limited partnership interest in Riverwalk Logistics, L.P. to the newly formed subsidiary.

On March 31, 2006, Holdings filed a registration statement on Form S-1 with the Securities and Exchange Commission for an initial public offering of approximately 37% of its units representing limited liability company interests. All units will be sold by subsidiaries of Valero Energy, which initially will retain an approximate 63% ownership interest in Holdings, the principal owner of our general partner interest and the general partner incentive distribution rights and the owner of 21.4% limited partner interest in us. In the registration statement, Valero Energy states its intention to further reduce and ultimately sell all of its interest in Holdings pending market conditions.

We conduct our operations through our subsidiaries, primarily Valero Logistics Operations, L.P. (Valero Logistics) and Kaneb Pipe Line Operating Partnership, L.P. (KPOP). We have four business segments: refined product terminals, refined product pipelines, crude oil pipelines and crude oil storage tanks.

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VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

New Accounting Pronouncements

FASB Statement No. 156

In March 2006, the FASB issued Statement No. 156, Accounting for Servicing of Financial Assets, which amends Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. Statement No. 156 requires the initial recognition at fair value of a servicing asset or servicing liability when an obligation to service a financial asset is undertaken by entering into a servicing contract. Statement No. 156 is effective for fiscal years beginning after September 15, 2006, with early adoption permitted. The adoption of Statement No. 156 is not expected to affect our financial position or results of operations.

FASB Statement No. 155

In February 2006, the FASB issued Statement No. 155, Accounting for Certain Hybrid Financial Instruments, which amends Statement No. 133, Accounting for Derivative Instruments and Hedging Activities, and Statement No. 140, Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities. This statement improves the financial reporting of certain hybrid financial instruments and simplifies the accounting for these instruments. In particular, Statement No. 155:

- permits fair value remeasurement for any hybrid financial instrument that contains an embedded derivative that otherwise would require bifurcation,
- clarifies which interest-only and principal-only strips are not subject to the requirements of Statement No. 133,
- establishes a requirement to evaluate interests in securitized financial assets to identify interests that are freestanding derivatives or that are hybrid financial instruments that contain an embedded derivative requiring bifurcation,
- clarifies that concentrations of credit risk in the form of subordination are not embedded derivatives, and
- amends Statement No. 140 to eliminate the prohibition on a qualifying special-purpose entity from holding a derivative financial instrument that pertains to a beneficial interest other than another derivative financial instrument.

Statement No. 155 is effective for all financial instruments acquired or issued after the beginning of an entity s fiscal year that begins after September 15, 2006, and is not expected to affect our financial position or results of operations.

2. ACQUISITIONS

Capwood Pipeline

We purchased a 23.77% interest in Capwood pipeline from Valero Energy for approximately $13.0 million, which was paid from borrowings under our existing revolving credit agreement. The Capwood pipeline is a 57-mile crude oil pipeline that extends from Patoka, Illinois to Wood River, Illinois. Plains All American Pipeline L.P., the operator of the Capwood pipeline, owns the remaining 76.23% interest. Our financial statements include the results of operations of our interest in the Capwood pipeline in the crude oil pipelines segment for the three months ended March 31, 2006.

The purchase price of the Capwood pipeline was primarily allocated to property and equipment. The pro forma financial information for the three months ended March 31, 2005 that give effect to the acquisition of the Capwood pipeline on January 1, 2005 has not been disclosed as the effect is not significant.

Kaneb Acquisition

On July 1, 2005, we completed our acquisition (the Kaneb Acquisition) of Kaneb Services LLC (KSL) and Kaneb Pipe Line Partners, L.P. (KPP, and, together with KSL, Kaneb).

The Kaneb Acquisition was accounted for using the purchase method. The purchase price has been preliminarily allocated based on the estimated fair values of the individual assets acquired and liabilities assumed at the date of acquisition pending completion of an independent appraisal and other evaluations.

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VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The purchase price and the preliminary purchase price allocation as of March 31, 2006 were as follows (in thousands):

Cash paid for the outstanding equity securities of KSL	$ 509,307
Value of Valero L.P. s common units issued in exchange for KPP common units	1,451,249
Transaction costs	9,403
Fair value of long-term debt assumed	779,707
Fair value of other liabilities assumed	172,687
Total	$ 2,922,353
Current assets	$ 602,085
Property and equipment	1,428,978
Goodwill	766,771
Intangible assets	58,900
Other noncurrent assets	65,619
Total	$ 2,922,353

The condensed statements of income include the results of operations of the Kaneb Acquisition commencing on July 1, 2005. As a result, information for the three months ended March 31, 2006 presented below represents actual results of operations. The unaudited pro forma financial information below includes the historical financial information of Kaneb and the Partnership for the period indicated. This financial information assumes the following:

we completed the Kaneb Acquisition on January 1, 2005;

we borrowed $525.0 million to purchase all of the outstanding equity securities of KSL,

we issued approximately 23.8 million common units in exchange for all of the outstanding common units of KPP,

we received a contribution from our general partner of $29.2 million to maintain its 2% interest;

and the results of operations of Martin Oil LLC (a marketing subsidiary of KSL), our Australia and New Zealand subsidiaries, and certain assets we divested in conjunction with the Kaneb Acquisition (Held Separate Businesses), are reported as discontinued operations.

The unaudited pro forma information is not necessarily indicative of the results of future operations:

	Three Months Ended March 31,	
	2006	2005
	(Thousands of Dollars, Except Per Unit Data)	

Revenues	$	274,004	$	219,032
Operating income		55,967		45,925
Income from continuing operations		39,589		32,393
Income (loss) from discontinued operations		(138)		3,788
Net income	$	39,451	$	36,181
Net income per unit applicable to limited partners:				
Continuing operations	$	0.75	$	0.61
Discontinued operations				0.08
Net income	$	0.75	$	0.69

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VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

3. DISPOSITIONS

Sale of Australia and New Zealand subsidiaries

On March 30, 2006, we sold our Australia and New Zealand subsidiaries to ANZ Terminals Pty. Ltd., for total proceeds of $65.0 million, plus working capital. The proceeds will be used for working capital purposes, including paying down outstanding debt. This transaction included the sale of eight terminals with an aggregate storage capacity of 1.1 million barrels. Revenues and pre-tax income related to the Australia and New Zealand subsidiaries, were included in loss from discontinued operations, and totaled $5.0 million and $0.6 million, respectively, for the three months ended March 31, 2006.

4. LONG-TERM DEBT

$400 Million Revolving Credit Agreement

During the three months ended March 31, 2006, we borrowed $34.0 million under our $400 million 2005 revolving credit agreement (the 2005 Revolving Credit Agreement) to fund the purchase of the Capwood pipeline and our capital expenditures. Additionally, we repaid $11.0 million during the three months ended March 31, 2006. The 2005 Revolving Credit Agreement bears interest based on either an alternative base rate or LIBOR, which was 5.5% as of March 31, 2006. As of March 31, 2006, we had $372.1 million available for borrowing under our 2005 Revolving Credit Agreement.

Interest Rate Swaps

As of March 31, 2006, the weighted-average interest rate for our interest rate swaps was 7.1%. As of March 31, 2006 and December 31, 2005, the aggregate estimated fair value of the interest rate swaps included in other long-term liabilities in our consolidated balance sheets was $7.9 million and $4.0 million, respectively.

Other

In Holding s registration statement on Form S-1, Valero Energy stated its intention to ultimately sell of its interest in Holdings pending market conditions. If Valero Energy ultimately sells all of its interests in Holdings, it will no longer own our general partner, which would trigger certain requirements in our debt instruments. As a result, we took the following actions:

- On April 19, 2006, Valero Logistics commenced a consent solicitation from the holders of its $100.0 million 6.875% senior notes due 2012 and its $250.0 million 6.05% senior notes due 2013 in order to amend the change of control covenant requiring that Valero Energy or an investment grade entity own 51% of our general partner interest as set forth in the indenture governing the notes of both such series. Holders of record as of April 18, 2006 who consent to the proposed amendment will receive $5.00 per $1,000 principal amount with respect to 6.05% Senior Notes and $2.50 per $1,000 principal amount with respect to the 6.875% senior notes. The consent solicitation will expire on May 10, 2006, unless further extended.

- In May 2006, we initiated discussions to amend the 2005 Revolving Credit Agreement, the $525 Term Loan Agreement and the UK Term Loan in order to eliminate the change in control provision requiring Valero Energy to own at least a majority of the outstanding equity interests in our general partner.

5. COMMITMENTS AND CONTINGENCIES

Litigation and Environmental Matters

We have contingent liabilities resulting from various litigation, claims and commitments, the most significant of which are discussed below. We record accruals for loss contingencies when losses are considered probable and can be reasonably estimated. Legal fees associated with defending ourselves in legal matters are expensed as incurred. As of March 31, 2006, we have recorded accruals for contingent losses, including settled matters, totaling $51.9 million. The actual payment of any amounts accrued and the timing of any such payments ultimately made is uncertain. We believe that should we be unable to successfully defend ourselves in any of these matters, the ultimate payment of any or all of the amounts reserved would not have a material adverse effect on our financial position or liquidity. However, if any actual losses ultimately exceed the amounts accrued, there could be a material adverse effect on our results of operations.

Grace Energy Corporation Matter. In 1997, Grace Energy Corporation (Grace Energy) sued subsidiaries of Kaneb in Texas state court. The complaint sought recovery of the cost of remediation of fuel leaks in the 1970s from a pipeline that had once connected a former Grace Energy terminal with Otis Air Force Base in Massachusetts (Otis AFB). Grace Energy alleges the Otis AFB pipeline and related environmental liabilities had been transferred in 1978 to an entity that was part of Kaneb s acquisition of Support Terminal Services, Inc. and its subsidiaries from Grace Energy in 1993. Kaneb contends that it did not acquire the Otis AFB pipeline and never assumed any responsibility for any associated environmental damage.

VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

In 2000, the court entered final judgment that: (i) Grace Energy could not recover its own remediation costs of $3.5 million, (ii) Kaneb owned the Otis AFB pipeline and its related environmental liabilities and (iii) Grace Energy was awarded $1.8 million in attorney costs. Both Kaneb and Grace Energy appealed the trial court s final judgment to the Texas Court of Appeals in Dallas. In 2001, Grace Energy filed a petition in bankruptcy, which created an automatic stay of actions against Grace Energy. Once that stay is lifted, we intend to resume vigorous prosecution of the appeal.

The Otis AFB is a part of a Superfund Site pursuant to the Comprehensive Environmental Response Compensation and Liability Act (CERCLA). The site contains a number of groundwater contamination plumes, two of which are allegedly associated with the Otis AFB pipeline. Relying on the Texas state court s final judgment assigning ownership of the Otis AFB pipeline to Kaneb, the U.S. Department of Justice advised Kaneb in 2001 that it intends to seek reimbursement from Kaneb for the remediation costs associated with the two spill areas. In 2002, the Department of Justice asserted that it had incurred over $49.0 million in costs and expected to incur additional costs of approximately $19.0 million for remediation of the two spill areas. The Department of Justice has not filed a lawsuit against us on this matter and we have not made any payments toward costs incurred by the Department of Justice.

Port of Vancouver Matter. We own a chemical and refined products terminal on property owned by the Port of Vancouver, and we lease the land under the terminal from the Port of Vancouver. Under an Agreed Order entered into with the Washington Department of Ecology when Kaneb purchased the terminal in 1998, Kaneb agreed to investigate and remediate groundwater contamination by the terminal s previous owner and operator originating from the terminal. Investigation and remediation at the terminal are ongoing, in compliance with the Agreed Order. In April 2006, the Washington Department of Ecology commented on our site investigation work plan and asserted that the groundwater contamination at the terminal was commingled with a groundwater contamination plume under other property owned by the Port of Vancouver. We dispute this assertion. No lawsuits have been filed against us in this matter, and our liability for any portion of total future remediation costs of the commingled plume is not reasonably estimable at this time. Factors that could affect estimated remediation costs include whether Kaneb will be found to have ultimate responsibility for some portion of the commingled plume, the Port of Vancouver s contribution to the remediation effort and the amount the Port of Vancouver actually receives from other potentially responsible parties.

Xanser Tax Indemnification. In 2001, Xanser, Inc (Xanser) distributed its interest in its pipeline, terminalling and product marketing business to its shareholders, which resulted in the formation of KSL. Pursuant to that distribution, KSL agreed to indemnify Xanser for certain potential tax liabilities, if any, that resulted from the distribution.

St. Eustatius Tax Agreement. On June 1, 1989, the governments of the Netherlands Antilles and St. Eustatius approved a Free Zone and Profit Tax Agreement retroactive to January 1, 1989, which expired on December 31, 2000. This agreement required a subsidiary of Kaneb, which we acquired on July 1, 2005, to pay the greater of 2% of taxable income, as defined therein, or 500,000 Netherlands Antilles guilders (approximately $0.3 million) per year. The agreement further provided that any amounts paid in order to meet the minimum annual payment were available to offset future tax liabilities under the agreement to the extent that the minimum annual payment is greater than 2% of taxable income.

On February 22, 2006, we entered into a revised agreement (the 2005 Tax and Maritime Agreement) with the governments of St. Eustatius and the Netherlands Antilles. The 2005 Tax and Maritime Agreement is effective beginning January 1, 2005 and expires on December 31, 2014. Under the terms of the 2005 Tax and Maritime Agreement, we agreed to make a one-time payment of five million Netherlands Antilles guilders (approximately $2.8 million) in full and final settlement of all of our liabilities, taxes, fees, levies, charges, or otherwise (including settlement of audits) due or potentially due to St. Eustatius. We further agreed to pay an annual minimum profit tax to St. Eustatius of one million Netherlands Antilles guilders (approximately $0.6 million), beginning as of January 1, 2005. We agreed to pay the minimum annual profit tax in twelve equal monthly installments. To the extent the minimum annual profit tax exceeds 2% of taxable profit (as defined in the 2005 Tax and Maritime Agreement), we can carry forward that excess to offset future tax liabilities. If the minimum annual profit tax is less than 2% of taxable profit, we agreed to pay that difference.

We are also a party to additional claims and legal proceedings arising in the ordinary course of business. We believe the possibility is remote that the final outcome of any of these claims or proceedings to which we are a party would

VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

have a material adverse effect on our financial position, results of operations or liquidity; however, due to the inherent uncertainty of litigation, there can be no assurance that the resolution of any particular claim or proceeding would not have a material adverse effect on our results of operations, financial position or liquidity.

Commitment

On April 13, 2006, we entered into an agreement to purchase three 30,000 barrel and two 52,000 barrel tank barges over the next two years. The contract price is $34.1 million, which is subject to adjustment based on the actual cost incurred for the steel.

6. RELATED PARTY TRANSACTIONS

We have related party transactions with Valero Energy for pipeline tariff, terminalling fee and crude oil storage tank fee revenues, which are comparable to the fees charged to third parties for similar services. In addition, we reimburse Valero Energy for the actual costs of Valero Energy employees working solely on our behalf and for charges incurred on our behalf.

Additionally, Valero Energy charges us an administrative service fee for certain administrative functions, primarily information systems support, ad valorem taxes, risk management, and human resources administration. If we cease to obtain such administrative services from Valero Energy our results of operations may be adversely impacted.

The receivable from Valero Energy as of March 31, 2006 and December 31, 2005 represents amounts due for pipeline tariff, terminalling fee and crude oil storage tank fee revenues and the payable to Valero Energy primarily represents amounts due for employee costs and the administrative service fee.

The following table summarizes information pertaining to transactions with Valero Energy:

	Three Months Ended March 31,	
	2006	2005
	(Thousands of Dollars)	
Revenues	$ 60,671	$ 55,341
Operating expenses	20,457	8,041
General and administrative expenses	5,700	2,757

Our share of allocated Valero Energy employee benefit plan expenses, excluding compensation expense related to restricted common units and unit options, was $7.8 million and $2.9 million for the three months ended March 31, 2006 and 2005, respectively. These employee benefit plan expenses and the related payroll costs are included in operating expenses and general and administrative expenses.

Services Agreement

For the three months ended March 31, 2005, Valero Energy charged us $0.3 million for administrative services. Effective July 1, 2005, the Services Agreement was amended (the 2005 Services Agreement) to account for our significant growth following the closing of the Kaneb Acquisition resulting in an increase in the administrative fee to $13.8 million for the first year from July 1, 2005 to June 30, 2006.

Effective January 1, 2006, pursuant to a new services agreement (2006 Services Agreement), Valero GP, LLC began directly performing many of the services previously provided by Valero Energy under the 2005 Services Agreement, primarily consisting of information systems, legal, corporate development and health, safety and environmental functions. The employees performing these services became employees of Valero GP, LLC, and their costs are now directly charged to us. Accordingly, the annual fee charged to us by Valero Energy for administrative services was reduced from $13.8 million to approximately $1.9 million per year. This annual fee will increase to approximately $2.9 million and $3.4 million in 2007 and 2008, respectively. The annual fee will remain at approximately $3.4 million through the term of the agreement. In addition, each annual fee will be subject to adjustments to account for Valero Energy s annual salary increase. Subject to approval by our Conflicts Committee, the amounts may also be adjusted for changed service levels.

The 2006 Services Agreement will expire on December 31, 2010 with automatic two-year renewal options unless terminated by either party at least six months prior to the renewal period. We may cancel or reduce the level of services that Valero Energy provides us on 60 days prior written notice. The 2006 Services Agreement will terminate upon the change of control of either Valero Energy or us.

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VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

New Omnibus Agreement

On March 31, 2006, Valero L.P. entered into an amended and restated omnibus agreement (the New Omnibus Agreement) with Valero Energy, Valero GP, LLC, Riverwalk Logistics, L.P., and Valero Logistics. The New Omnibus Agreement amended certain definitions and other provisions in the April 16, 2001 omnibus agreement, which it supersedes, to clarify the parties intent as to the Valero Energy ownership requirements for the application of the business restrictions described below.

Under the New Omnibus Agreement, Valero Energy has agreed, and will cause its controlled affiliates to agree, for so long as Valero Energy owns 20% or more of us or our general partner, not to engage in the business of transporting crude oil and other feedstocks or refined products, including petrochemicals, or operating crude oil storage facilities or refined product terminalling assets in the United States. This restriction does not apply to:

- any business retained by Ultramar Diamond Shamrock (UDS) as of April 16, 2001, the closing of our initial public offering, or any business owned by Valero Energy at the date of its acquisition of UDS on December 31, 2001;
- any business with a fair market value of less than $10 million;
- any business acquired by Valero Energy in the future that constitutes less than 50% of the fair market value of a larger acquisition, provided we have been offered and declined the opportunity to purchase the business; and
- any newly constructed pipeline, terminalling or storage assets that we have not offered to purchase at fair market value within one year of construction.

Also under the New Omnibus Agreement, Valero Energy has agreed to indemnify us for environmental liabilities related to the assets transferred to us in connection with our initial public offering, provided that such liabilities arose prior to and are discovered within ten years after that date (excluding liabilities resulting from a change in law after April 16, 2001).

7. PARTNERS EQUITY

Outstanding Equity

We have identified our general partner interest and subordinated units as participating securities and we use the two-class method when calculating net income per unit applicable to limited partners, which is based on the weighted-average number of common and subordinated units outstanding during the period. Net income per unit applicable to limited partners is computed by dividing net income applicable to limited partners, after deducting the general partner s 2% interest and incentive distributions, by the weighted-average number of limited partnership units outstanding. Basic and diluted net income per unit applicable to limited partners is the same because we have no potentially dilutive securities outstanding.

Cash Distributions

On January 27, 2006, we declared a quarterly cash distribution of $0.855 per unit paid on February 14, 2006 to unitholders of record on February 7, 2006, which totaled $44.0 million. On April 18, 2006, we declared a quarterly cash distribution of $0.885 per unit to be paid on May 12, 2006 to unitholders of record on May 5, 2006, which totaled $45.8 million.

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VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

The following table reflects the allocation of total cash distributions to the general and limited partners applicable to the period in which the distributions were earned:

	Three Months Ended March 31, 2006	2005
	(Thousands of Dollars, Except Per Unit Data)	
General partner interest	$ 916	$ 399
General partner incentive distribution	3,480	1,112
Total general partner distribution	4,396	1,511
Limited partners distribution	41,427	18,433
Total cash distributions	$ 45,823	$ 19,944
Cash distributions per unit applicable to limited partners	$ 0.885	$ 0.800

Subordinated Units

We satisfied all the conditions included in our partnership agreement for the subordination period to end. Accordingly, the subordination period ended effective April 1, 2006 and all 9,599,322 subordinated units converted into common units on a one-for-one basis on May 8, 2006, the first business day after the record date for the distribution related to the first quarter earnings of 2006. Riverwalk Holdings, LLC held the 9,599,322 subordinated units at the time of conversion.

Comprehensive Income

For the three months ended March 31, 2006, the difference between our net income and our comprehensive income resulted from foreign currency translation adjustments. Our total comprehensive income was as follows:

	Three Months Ended March 31, 2006	2005
	(Thousands of Dollars)	
Net income	$ 39,451	$ 19,264
Foreign currency translation adjustment	2,201	
Comprehensive income	$ 41,652	$ 19,264

8. SEGMENT INFORMATION

Our operating segments consist of refined product terminals, refined product pipelines, crude oil pipelines and crude oil storage tanks. The operations related to the Kaneb Acquisition on July 1, 2005 principally involve transporting refined petroleum products and fertilizer as a common carrier, the storage of petroleum products, specialty chemicals, and other liquids. In addition, we also deliver and sell bunker fuel at St. Eustatius, Netherlands Antilles and Point Tupper, Nova Scotia. The results of Kaneb s transportation operations are included in our refined product pipelines segment. The results of Kaneb s storage and bunker fuel operations are included in our refined product terminals segment.

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VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

Results of operations for the reportable segments were as follows:

	Three Months Ended March 31, 2006	2005
	(Thousands of Dollars)	
Revenues:		
Refined product terminals	$ 196,148	$ 9,937
Refined product pipelines	52,046	22,182
Crude oil pipelines	14,049	13,185
Crude oil storage tanks	11,761	11,331
Total revenues	$ 274,004	$ 56,635
Operating income:		
Refined product terminals	$ 27,045	$ 3,581
Refined product pipelines	22,105	9,022
Crude oil pipelines	9,103	8,216
Crude oil storage tanks	6,274	7,399
Total segment operating income	64,527	28,218
Less general and administrative expenses	8,560	3,503
Total operating income	$ 55,967	$ 24,715

Revenues from Valero Energy by operating segment were as follows:

	Three Months Ended March 31, 2006	2005
	(Thousands of Dollars)	
Revenues:		
Refined product terminals	$ 11,019	$ 9,790
Refined product pipelines	24,356	21,035
Crude oil pipelines	13,535	13,185
Crude oil storage tanks	11,761	11,331
Total revenues	$ 60,671	$ 55,341

Total assets by reportable segment were as follows:

	March 31, 2006	December 31, 2005
	(Thousands of Dollars)	
Refined product terminals	$ 1,587,257	$ 1,701,782
Refined product pipelines	1,293,179	1,286,571
Crude oil pipelines	123,320	123,698

Crude oil storage tanks	202,991	204,580
Total segment assets	3,206,747	3,316,631
General partnership assets assets and other noncurrent assets)	116,433	50,361
Total consolidated assets	$ 3,323,180	$ 3,366,992

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VALERO L.P. AND SUBSIDIARIES

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS (Continued)

9. CONDENSED CONSOLIDATING FINANCIAL STATEMENTS

Valero L.P. has no operations and its assets consist mainly of its investments in Valero Logistics, KSL and KPP. KPP is the majority owner of KPOP. Valero Logistics and KPOP are 100% indirectly owned by Valero L.P. Valero Logistics and KPOP own and operate pipelines, terminals and storage tanks and are issuers of publicly traded senior notes. The senior notes issued by Valero Logistics were and continue to be fully and unconditionally guaranteed by Valero L.P. In connection with the Kaneb Acquisition, effective July 1, 2005, Valero L.P. fully and unconditionally guaranteed the outstanding senior notes issued by KPOP. Additionally, effective July 1, 2005, both Valero Logistics and KPOP fully and unconditionally guaranteed the outstanding senior notes of the other. All guarantors are jointly and severally liable for performance under the terms of the guarantees.

As a result, the following condensed consolidating financial statements are being presented for the current year as an alternative to providing separate financial statements for Valero Logistics and KPOP. Condensed consolidating statements of income for the comparable periods of 2005 are not presented as we did not own Kaneb.

Condensed Consolidating Balance Sheet

March 31, 2006

(Thousands of Dollars)

	Valero L.P.	Valero Logistics Operations, L.P.	Kaneb Pipe Line Operating Partnership L.P.	Non-Guarantor Subsidiaries (a)	Eliminations	Valero L.P. Consolidated
Assets						
Current assets	$ 43	$ 165,827	$ 629,927	$ 131,330	$ (675,898)	$ 251,229
Property and equipment, net		784,678	684,804	687,070		2,156,552
Goodwill		4,715	194,509	572,262		771,486
Investment in wholly owned subsidiaries	2,399,920	31,691	622,813	1,293,346	(4,347,770)	
Equity investments		15,102		58,692		73,794
Other noncurrent assets, net	228	9,202	722	59,967		70,119
Total assets	$ 2,400,191	$ 1,011,215	$ 2,132,775	$ 2,802,667	$ (5,023,668)	$ 3,323,180
Liabilities and Partners Equity						
Current liabilities Current liabilities	$ 502,644	$ 36,687	$ 37,634	$ 243,674	$ (675,898)	$ 144,741
Long-term debt, less current portion		601,039	550,154	36,469		1,187,662
Long-term payable to Valero Energy				5,851		5,851
Deferred income taxes				9,477		9,477
Other long-term liabilities		8,652	4,549	63,768		76,969
Total partners equity	1,897,547	364,837	1,540,438	2,443,428	(4,347,770)	1,898,480