

VALERO L P  
Form 10-Q  
November 09, 2005

**UNITED STATES  
SECURITIES AND EXCHANGE COMMISSION**

Washington, D.C. 20549

**FORM 10-Q**

(Mark One)

✓

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

For the quarterly period ended September 30, 2005

OR

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**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**  
(State or other jurisdiction of  
incorporation or organization)

**74-2956831**  
(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**  **No**

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Securities Exchange Act).  
**Yes**  **No**

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes  No

The number of common and subordinated units outstanding as of October 31, 2005 was 37,210,427 and 9,599,322, respectively.

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VALERO L.P. AND SUBSIDIARIES

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**PART I FINANCIAL INFORMATION**

**Item 1. Financial Statements**

**VALERO L.P. AND SUBSIDIARIES**

**CONSOLIDATED BALANCE SHEETS**

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(Thousands of Dollars, Except Unit Data)

	September 30, 2005 (Unaudited)	December 31, 2004
<b>Assets</b>		
Current assets:		
Cash and cash equivalents	\$ 41,678	\$ 16,147
Receivable from Valero Energy	20,538	19,195
Accounts receivable, net	85,864	3,395
Finished goods inventories	13,358	
Other current assets	13,108	1,242
Total current assets	174,546	39,979
Property and equipment	2,447,096	981,360
Accumulated depreciation and amortization	(237,181)	(196,361)
Property and equipment, net	2,209,915	784,999
Goodwill	875,428	4,715
Investment in joint ventures	41,183	15,674
Other noncurrent assets, net	11,469	12,140
Total assets	\$ 3,312,541	\$ 857,507
<b>Liabilities and Partners Equity</b>		
Current liabilities:		
Current portion of long-term debt	\$ 524	\$ 990
Payable to Valero Energy	11,694	4,166
Accounts payable and other accrued liabilities	101,612	16,055
Accrued interest payable	9,488	7,693
Taxes other than income taxes	13,333	4,705
Income taxes payable	1,936	
Total current liabilities	138,587	33,609
Long-term debt, less current portion	1,174,949	384,171
Deferred income taxes	8,692	
Other long-term liabilities	71,380	1,416
Commitments and contingencies (Note 5)		
Partners equity:		
Common units (37,210,427 and 13,442,072 outstanding as of September 30, 2005 and December 31, 2004, respectively)	1,761,620	310,507
Subordinated units (9,599,322 outstanding as of September 30, 2005 and December 31, 2004)	117,374	117,968
General partner's equity	39,298	9,836
Accumulated other comprehensive income	641	
Total partners equity	1,918,933	438,311
Total liabilities and partners equity	\$ 3,312,541	\$ 857,507

See Condensed Notes to Consolidated Financial Statements.



**VALERO L.P. AND SUBSIDIARIES**

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**CONSOLIDATED STATEMENTS OF INCOME**

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
<b>Revenues:</b>				
Services	\$ 153,371	\$ 58,075	\$ 268,312	\$ 166,106
Product	110,175		110,175	
<b>Total revenues</b>	<b>263,546</b>	<b>58,075</b>	<b>378,487</b>	<b>166,106</b>
<b>Costs and expenses:</b>				
Cost of sales	101,217		101,217	
Operating expenses	71,358	21,626	112,688	59,746
General and administrative expenses	10,391	3,588	17,455	8,233
Depreciation and amortization expense	23,902	8,413	41,425	24,536
<b>Total costs and expenses</b>	<b>206,868</b>	<b>33,627</b>	<b>272,785</b>	<b>92,515</b>
<b>Operating income</b>	<b>56,678</b>	<b>24,448</b>	<b>105,702</b>	<b>73,591</b>
Equity earnings in joint ventures	1,541	372	2,340	1,102
Interest and other expense, net	(15,315)	(5,433)	(27,022)	(15,630)
<b>Income from continuing operations before income tax expense</b>	<b>42,904</b>	<b>19,387</b>	<b>81,020</b>	<b>59,063</b>
Income tax expense	2,147		2,147	
<b>Income from continuing operations</b>	<b>40,757</b>	<b>19,387</b>	<b>78,873</b>	<b>59,063</b>
<b>Income from discontinued operations</b>	<b>4,410</b>		<b>4,410</b>	
<b>Net income</b>	<b>45,167</b>	<b>19,387</b>	<b>83,283</b>	<b>59,063</b>
Less general partner's interest and incentive distributions	(3,892)	(1,478)	(7,215)	(4,451)
<b>Limited partners' interest in net income</b>	<b>\$ 41,275</b>	<b>\$ 17,909</b>	<b>\$ 76,068</b>	<b>\$ 54,612</b>
<b>Weighted-average units outstanding</b>	<b>46,809,749</b>	<b>23,041,394</b>	<b>31,051,243</b>	<b>23,041,394</b>
<b>Net income per unit applicable to limited partners:</b>				
Continuing operations	\$ 0.79	\$ 0.78	\$ 2.31	\$ 2.37
Discontinued operations	0.09		0.14	
Net income	\$ 0.88	\$ 0.78	\$ 2.45	\$ 2.37
Cash distributions per unit applicable to limited partners	\$ 0.855	\$ 0.800	\$ 2.510	\$ 2.400

See Condensed Notes to Consolidated Financial Statements.



**VALERO L.P. AND SUBSIDIARIES**

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**CONSOLIDATED STATEMENTS OF CASH FLOWS**

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(Unaudited, Thousands of Dollars)

	Nine Months Ended September 30,	
	2005	2004
<b>Cash Flows from Operating Activities:</b>		
Net income	\$ 83,283	\$ 59,063
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	41,425	24,536
Equity income from joint ventures	(2,340)	(1,102)
Distributions from joint ventures	2,488	1,102
Changes in operating assets and liabilities:		
Increase in receivable from Valero Energy	(1,343)	(2,793)
(Increase) decrease in accounts receivable	(10,680)	1,905
Increase in finished goods inventories	(1,928)	
Increase in other current assets	(1,334)	(588)
Increase (decrease) in accounts payable, accrued interest payable and other accrued liabilities	12,809	(1,987)
Increase (decrease) in payable to Valero Energy	7,528	(6,066)
Increase in taxes other than income taxes	2,019	971
Other, net	3,471	550
<b>Net cash provided by operating activities</b>	<b>135,398</b>	<b>75,591</b>
<b>Cash Flows from Investing Activities:</b>		
Reliability capital expenditures	(12,369)	(7,030)
Expansion capital expenditures	(28,926)	(17,942)
Kaneb acquisition, net of cash acquired	(505,669)	
Other acquisitions		(28,085)
Investment in other noncurrent assets	(999)	
Proceeds from sale of Held Separate Businesses, net	454,109	
Proceeds from sales of other assets	26,788	33
Distributions in excess of equity income from joint ventures		121
<b>Net cash used in investing activities</b>	<b>(67,066)</b>	<b>(52,903)</b>
<b>Cash Flows from Financing Activities:</b>		
Long-term borrowings, net of issuance costs	713,194	43,000
Long-term debt repayments	(700,520)	(5,450)
Contributions from general partner	29,197	
Distributions to unitholders and general partner	(83,839)	(58,296)
<b>Net cash used in financing activities</b>	<b>(41,968)</b>	<b>(20,746)</b>
Effect of foreign exchange rate changes on cash	(833)	
Net increase in cash and cash equivalents	25,531	1,942
Cash and cash equivalents at the beginning of the period	16,147	15,745
Cash and cash equivalents at the end of the period	\$ 41,678	\$ 17,687
<b>Supplemental cash flow information:</b>		
Cash paid during the period for interest	\$ 37,013	\$ 23,564
Cash paid during the period for income taxes	\$ 47	\$

See Condensed Notes to Consolidated Financial Statements.

**VALERO L.P. AND SUBSIDIARIES**

**CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS**

**1. BASIS OF PRESENTATION, PRINCIPLES OF CONSOLIDATION AND SIGNIFICANT ACCOUNTING POLICIES**

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.

These unaudited consolidated financial statements have been prepared in accordance with United States generally accepted accounting principles (GAAP) for interim financial information and with the instructions to Form 10-Q and Article 10 of Regulation S-X of the Securities Exchange Act of 1934. Accordingly, they do not include all of the information and notes required by GAAP for complete consolidated financial statements. In the opinion of management, all adjustments considered necessary for a fair presentation have been included. All such adjustments are of a normal recurring nature unless disclosed otherwise. Financial information for the three and nine months ended September 30, 2005 and 2004 included in these Condensed Notes to Consolidated Financial Statements is derived from Valero L.P.'s unaudited consolidated financial statements. Operating results for the three and nine months ended September 30, 2005 are not necessarily indicative of the results that may be expected for the year ending December 31, 2005.

The consolidated balance sheet as of December 31, 2004 has been derived from the audited 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, 2004.

***FASB Interpretation No. 47***

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

Effective July 1, 2005 with the Kaneb Acquisition (See Note 2), we adopted the following accounting policies:



***Inventories***

Finished goods inventories consist of petroleum products purchased for resale and are valued at the lower of cost or market. Cost is determined by using the weighted-average cost method.

***Revenue Recognition***

Revenues for the product sales business are recognized when product is sold and title and risk pass to the customer.

***Income Taxes***

Partnership operations are not subject to federal or state income taxes. However, certain of our operations are conducted through wholly-owned corporate subsidiaries which are taxable entities. The provision for income taxes consists of U.S. and foreign income taxes related to our corporate subsidiaries.

Since the income or loss of the operations which are conducted through limited partnerships will be included in the tax returns of the individual partners of the Partnership, no provision for income taxes has been recorded in the accompanying financial statements on these earnings. The tax returns of the Partnership are subject to examination by federal and state taxing authorities. If any such examination results in adjustments to distributive shares of taxable income or loss, the tax liability of the partners would be adjusted accordingly.

## **2. KANEB ACQUISITION**

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

We acquired all of KSL s outstanding equity securities for approximately \$509 million of cash which was primarily funded by borrowings under a \$525 million term credit agreement. Additionally, we issued approximately 23.8 million of our common units valued at approximately \$1,451 million in exchange for all of the outstanding common units of KPP.

The Kaneb Acquisition expands our geographic presence and creates one of the largest terminal and pipeline operations in the United States. The Kaneb Acquisition also provides us with a more diversified customer base, which minimizes our dependence on one customer.

### *Purchase Price Allocation*

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.

As of September 30, 2005, the preliminary purchase price allocation was as follows (in thousands):

Current assets	\$	591,553
Property and equipment		1,423,602
Goodwill		870,713
Other noncurrent assets		27,440
Current liabilities		(253,740)
Long-term liabilities		(684,646)
Total	\$	1,974,922

### *Unaudited Pro Forma Information*

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 September 30, 2005 presented below represents actual results of operations. The following unaudited pro forma financial information assumes that the Kaneb Acquisition occurred on January 1, 2005 and 2004. This pro forma information assumes:

\$525 million borrowed to purchase KSL,

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

the results of the Held Separate Businesses and the results of Martin Oil LLC, (a marketing subsidiary of KSL) are reported as discontinued operations (See Note 3).

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The unaudited pro forma information is not necessarily indicative of the results of future operations (in thousands, except per unit data):

	<b>Three Months Ended September 30,</b>		<b>Nine Months Ended September 30,</b>	
	<b>2005</b>	<b>2004</b>	<b>2005</b>	<b>2004</b>
Revenues	\$ 263,546	\$ 211,245	\$ 737,247	\$ 592,304
Operating income	56,678	47,667	87,297	145,041
Income from continuing operations	40,757	33,474	55,564	104,422
Income from discontinued operations	4,410	4,083	11,322	9,802
Net income	\$ 45,167	\$ 37,557	\$ 66,886	\$ 114,224
Net income per unit applicable to limited partners:				
Continuing operations	\$ 0.79	\$ 0.63	\$ 0.97	\$ 1.99
Discontinued operations	0.09	0.09	0.24	0.21
Net income	\$ 0.88	\$ 0.72	\$ 1.21	\$ 2.20

### 3. DISPOSITIONS

***Sale of Held Separate Businesses***

In conjunction with the Kaneb Acquisition, we agreed with the United States Federal Trade Commission to divest certain assets. These assets consisted of two California terminals handling refined products, blendstocks, and crude oil, three East Coast refined product terminals, and a 550-mile refined products pipeline with four truck terminals and storage in the U.S. Rocky Mountains collectively, the Held Separate Businesses.

On September 30, 2005, we sold the Held Separate Businesses to Pacific Energy Partners, L.P. ( Pacific ) for approximately \$455 million. Results of operations related to the Held Separate Businesses are classified as discontinued operations in the consolidated statements of income for the three and nine months ended September 30, 2005. Revenues and net income for the Held Separate Businesses were \$14.2 million and \$4.4 million, respectively for the three and nine months ended September 30, 2005. Additionally, income from discontinued operations includes interest expense of approximately \$4.9 million. Interest expense was allocated to the discontinued operations as certain of our debt agreements required us to use the proceeds from the sale of the Held Separate Businesses to repay outstanding debt.

***Sale of Martin Oil LLC***

On July 1, 2005, we sold all of our equity interest in Martin Oil LLC, previously a wholly owned subsidiary of KSL, to Valero Marketing and Supply Company ( Valero Marketing ) for approximately \$26.8 million. Valero Marketing is a wholly owned subsidiary of Valero Energy Corporation (Valero Energy).

**4. LONG-TERM DEBT**

***\$525 Million Term Credit Agreement***

On July 1, 2005, we borrowed \$525 million under a 2005 term credit agreement dated July 1, 2005 ( *2005 Term Credit Agreement* ), the majority of which was used to purchase KSL. The 2005 Term Credit Agreement expires on July 1, 2010 and bears interest based on either an alternative base rate or LIBOR, which was 4.6% as of September 30, 2005. With a portion of the proceeds received from the sale of the Held Separate Businesses, we repaid \$295 million of the outstanding balance on September 30, 2005. Our outstanding balance at September 30, 2005 was \$230 million. No additional funds may be borrowed under the 2005 Term Credit Agreement.

***\$400 Million Revolving Credit Agreement***

On July 1, 2005, we borrowed \$180 million under our \$400 million 2005 revolving credit agreement ( *2005 Revolving Credit Agreement* ), which expires on July 1, 2010 and bears interest based on either an alternative base

rate or LIBOR, which was 4.6% as of September 30, 2005. Also on July 1, 2005, the \$180 million of proceeds were used in conjunction with other proceeds and cash on hand to retire approximately \$191.5 million of the outstanding indebtedness of KPP and KSL and to repay \$38.0 million of indebtedness outstanding on our prior \$175 million revolving credit facility. During the quarter ended September 30, 2005, we repaid the full amount outstanding, including \$160 million using a portion of the proceeds from the sale of the Held Separate Businesses on September 30, 2005. As of September 30, 2005, we had \$399.1 million available for borrowing.

#### ***Senior Notes***

As part of the Kaneb Acquisition, we assumed the outstanding senior notes issued by Kaneb Pipe Line Operating Partnership, L.P. ( KPOP ), a subsidiary of KPP, having an aggregate face value of \$500 million, and an aggregate fair value of \$555 million. The difference between the fair value and the face value of the senior notes is being amortized as a reduction of interest expense over the remaining lives of the senior notes using the effective interest method. The senior notes were issued in two series, the first of which bears interest at 7.75% annually (due semi-annually on February 15 and August 15) and matures February 15, 2012. The second series bears interest at 5.875% annually (due on June 1 and December 1) and matures June 1, 2013.

#### ***UK Term Loan***

As part of the Kaneb Acquisition, we assumed the outstanding term loan of 21,000,000 Sterling ( UK Term Loan ) with a face value of \$37 million as of September 30, 2005. The UK Term Loan bears interest at 6.65% annually and matures June 30, 2010.

#### ***\$175 Million Revolving Credit Facility***

We terminated our \$175 million credit facility on July 1, 2005 by repaying the \$38 million outstanding amount using proceeds from our new five-year \$400 million 2005 Revolving Credit Agreement.

#### ***Interest Rate Swaps***

As of September 30, 2005, the weighted-average interest rate for our interest rate swaps was 6.3%. As of September 30, 2005 and December 31, 2004, the aggregate estimated fair value of the interest rate swaps included in other long-term liabilities in our consolidated balance sheets was \$2.6 million and \$1.2 million, respectively.

### **5. COMMITMENTS AND CONTINGENCIES**

#### ***Litigation and Environmental Matters***

We have contingent liabilities resulting from various litigation, claims and commitments, some of which are discussed below. We have recorded estimated reserves in compliance with generally accepted accounting principles related to certain matters for which losses are considered probable and can be reasonably estimated. The actual payment of any amounts reserved and the timing of 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.

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

### *Grace Matter*

In 1997, Grace Energy Corporation ( Grace ) sued subsidiaries of KPP (hereafter, collectively or individually, KPP ) 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 terminal with Otis Air Force Base in Massachusetts (the Otis pipeline ). Grace alleges the Otis pipeline and related environmental liabilities had been transferred in 1978 to an entity that was part of KPP 's acquisition of Support Terminal Services, Inc. and its subsidiaries from Grace in 1993. KPP contends that it did not acquire the Otis pipeline and never assumed any responsibility for any associated environmental damage.

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

The Otis Air Force Base is a part of a Superfund Site (pursuant to CERCLA). The site contains a number of groundwater contamination plumes, two of which are allegedly associated with the Otis pipeline. Relying on the Texas state court 's final judgment assigning ownership of the Otis pipeline to KPP, the U.S. Department of Justice ( DOJ ) advised KPP in 2001 that it intends to seek reimbursement from KPP for the remediation costs associated with the two spill areas. In 2002, the DOJ asserted that it had incurred over \$49 million in costs and expected to incur additional costs of approximately \$19 million for remediation of the two spill areas. The DOJ has not filed a



lawsuit against KPP on this matter. We do not believe this matter will have a material adverse effect on our financial condition, although there can be no assurances as to the ultimate outcome.

***PEPCO Matter***

On December 14, 2002, PEPCO sued KPP in the U.S. District Court for the District of Maryland, seeking recovery of all its costs associated with an oil spill in 2000 resulting from a rupture in a fuel oil pipeline in Maryland owned by Potomac Electric Power Company ( PEPCO ) and operated by KPP. PEPCO alleges that it has incurred costs of approximately \$80 million as a result of the spill.

At the time of filing of this report, KPP and PEPCO have been participating in voluntary mediation to settle this litigation. KPP expects that a settlement will be reached and finalized by the end of 2005. We believe that the majority of costs or damages resulting from these matters will be covered by insurance and therefore will not materially adversely affect our financial condition.

***Port of Vancouver***

We own a refined products terminal on property owned by the Port of Vancouver ( Port ), and we lease the land under the terminal from the Port. Under an Agreed Order entered into with the Washington Department of Ecology ( WDE ) when KPP purchased the terminal in 1998, KPP agreed to investigate and remediate a groundwater plume contaminated by the terminal s previous owner and operator. KPP has submitted a final remedial action plan to WDE, and is waiting for WDE to approve that plan. The Port also owns property near the terminal site that has been contaminated by other parties, some of which are in bankruptcy. Estimated costs to remediate the terminal site depend on a number of factors, including the outcome of litigation involving the other properties owned by the Port that are near the terminal site. No lawsuits have been filed against KPP in this matter, and our liability for any portion of total future remediation costs is not reasonably estimable at this time.

**6. RELATED PARTY TRANSACTIONS**

We have related party transactions with Valero Energy for pipeline tariff, terminalling fee, crude oil storage tank rent and fee revenues, certain employee costs, insurance costs, operating expenses, administrative costs and rent expense. Under the terms of a services agreement with Valero Energy ( Services Agreement ), we reimburse Valero Energy for payroll costs of employees working on our behalf. Additionally, Valero Energy charges us an administrative services fee.

Our share of allocated Valero Energy employee benefit plan expenses, excluding compensation expense related to restricted common units and unit options, was \$8.9 million and \$3.2 million for the three months ended September 30, 2005 and 2004, respectively, and was \$15.0 and \$8.4 million for the nine months ended September 30, 2005 and 2004, respectively. These employee benefit plan expenses and the related payroll costs are included in operating expenses and general and administrative expenses.

Effective July 1, 2005, the Services Agreement was amended to account for significant growth of the Partnership following the closing of the Kaneb Acquisition. The amended agreement provides that the annual service fee will be \$13.8 million for the first year from July 1, 2005 to June 30, 2006, \$14.8 million for the second year and \$15.8 million for each of the three years thereafter. Under the amended agreement, the annual service fee will be adjusted to account for Valero Energy's annual salary increase and may also be adjusted for changed service levels due to our acquisition, sale or construction of assets. In addition, the Partnership agreed to perform certain services for Valero Energy, including control room services, terminal operations oversight, mapping support and integrity management program planning in exchange for an annual fee.

Summarized results of transactions with Valero Energy were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(Thousands of Dollars)			
Revenues	\$ 63,999	\$ 57,261	\$ 176,694	\$ 163,492
Operating expenses	22,246	8,615	38,907	24,128
General and administrative expenses	6,908	3,202	12,708	7,131

## 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 July 21, 2005, we declared a quarterly cash distribution of \$0.855 per unit paid on August 12, 2005 to unitholders of record on August 5, 2005. On October 26, 2005, we declared a quarterly cash distribution of \$0.855 per unit to be paid on November 14, 2005 to unitholders of record on November 7, 2005, which totaled \$43.9 million.

Allocations of total cash distributions to the general and limited partners applicable to the period in which the distributions were earned were as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(Thousands of Dollars, Except Per Unit Data)			
General partner interest	\$ 879	\$ 399	\$ 1,711	\$ 1,197
General partner incentive distribution	3,049	1,112	5,662	3,336
Total general partner distribution	3,928	1,511	7,373	4,533
Limited partners distribution	40,022	18,433	78,155	55,299
Total cash distributions	\$ 43,950	\$ 19,944	\$ 85,528	\$ 59,832
Cash distributions per unit applicable to limited partners	\$ 0.855	\$ 0.800	\$ 2.510	\$ 2.400

## 4. LONG-TERM DEBT



**Comprehensive Income**

For the three and nine months ended September 30, 2005, 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 September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
	(Thousands of Dollars)			
Net income	\$ 45,167	\$ 19,387	\$ 83,283	\$ 59,063
Foreign currency translation adjustment	641		641	
Comprehensive income	\$ 45,808	\$ 19,387	\$ 83,924	\$ 59,063

**8. SEGMENT INFORMATION**

We have four reportable business segments: crude oil pipelines, refined product pipelines, refined product terminals and crude oil storage tanks. The operations related to the Kaneb Acquisition principally involve transporting refined petroleum products and fertilizer as a common carrier, the storage of petroleum products, specialty chemicals, and other liquids, and delivery and sale of bunker fuel to ships at St. Eustatius in the Caribbean and Point Tupper in Nova Scotia, Canada. The results of Kaneb's transportation operations are included in our refined product pipelines segment. The results of Kaneb's storage and bunker sales operations are included in our refined product terminals segment.

Segment information for our four reportable segments was as follows:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2005	2004	2005	2004
(Thousands of Dollars)				
<b>Revenues:</b>				
Crude oil pipelines	\$ 14,041	\$ 13,231	\$ 39,601	\$ 39,462
Refined product pipelines	53,749	22,324	98,609	63,764
Refined product terminals	184,134	11,150	205,555	30,259
Crude oil storage tanks	11,622	11,370	34,722	32,621
Total revenues	\$ 263,546	\$ 58,075	\$ 378,487	\$ 166,106
<b>Operating income:</b>				
Crude oil pipelines	\$ 8,431	\$ 7,870	\$ 23,680	\$ 24,269
Refined product pipelines	23,470	8,141	41,714	24,426
Refined product terminals	27,432	4,753	34,912	11,736
Crude oil storage tanks	7,736	7,272	22,851	21,393
Total segment operating income	67,069	28,036	123,157	81,824
Less general and administrative expenses	10,391	3,588	17,455	8,233
Total operating income	\$ 56,678	\$ 24,448	\$ 105,702	\$ 73,591

Total assets by reportable segment were as follows:

	September 30, 2005	December 31, 2004
(Thousands of Dollars)		
Crude oil pipelines	\$ 124,609	\$ 127,668
Refined product pipelines	1,105,703	347,008
Refined product terminals	1,822,969	145,966
Crude oil storage tanks	206,216	209,919
Total segment assets	3,259,497	830,561
General partnership assets	53,044	26,946
Total consolidated assets	\$ 3,312,541	\$ 857,507

**9. CONDENSED CONSOLIDATING FINANCIAL STATEMENTS**

Valero L.P. has no operations and its assets consist mainly of its investments in Valero Logistics Operations, L.P. ( Valero Logistics ), KSL and KPP. KPP is the majority owner of KPOP. 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.

As a result, the following condensed consolidating financial statements are being presented for the current year periods as an alternative to providing separate financial statements for Valero Logistics and KPOP. Condensed consolidating financial statements for the comparable periods of 2004 are not presented as the guarantees of KPOP's senior notes by Valero L.P. and Valero Logistics were not in effect for those periods of 2004, nor were KSL, KPP or KPOP included in the consolidated financial statements of Valero L.P.

### Condensed Consolidating Balance Sheet

September 30, 2005

(Thousands of Dollars)

	Valero L.P.	Valero Logistics Operations, L.P.	Kaneb Pipe Line Operating Partnership L.P.	Non-Guarantor Subsidiaries	Eliminations	Valero L.P. Consolidated
<b>Assets</b>						
Current assets	\$ 70	\$ 24,693	\$ 22,546	\$ 127,237	\$	\$ 174,546
Intercompany notes receivable		187,162	750,232		(937,394)	
Property and equipment, net		780,686	461,939	967,290		2,209,915
Goodwill		4,715	264,165	606,548		875,428
Equity investments	2,418,743	30,809	586,925	1,534,149	(4,529,443)	41,183
Other noncurrent assets, net	228	8,703	16	2,522		11,469
Total assets	\$ 2,419,041	\$ 1,036,768	\$ 2,085,823	\$ 3,237,746	\$ (5,466,837)	\$ 3,312,541
<b>Liabilities and Partners Equity</b>						
Current liabilities	\$ 3,606	\$ 29,970	\$ 21,353	\$ 83,658	\$	\$ 138,587
Intercompany notes payable	497,143			440,251	(937,394)	
Long-term debt, less current portion		584,882	553,023	37,044		1,174,949
Deferred income taxes				8,692		8,692
Other long-term liabilities		3,225	2,189	65,966		71,380
Total partners' equity	1,918,292	418,691	1,509,258	2,602,135	(4,529,443)	1,918,933
Total liabilities and partners' equity	\$ 2,419,041	\$ 1,036,768	\$ 2,085,823	\$ 3,237,746	\$ (5,466,837)	\$ 3,312,541



**Condensed Consolidating Statements of Income****For the Three Months Ended September 30, 2005****(Thousands of Dollars)**

	<b>Valero L.P.</b>	<b>Valero Logistics Operations, L.P.</b>	<b>Kaneb Pipe Line Operating Partnership L.P.</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Valero L.P. Consolidated</b>	
Revenues	\$	\$ 62,237	\$ 29,560	\$ 171,965	\$ (216)	\$ 263,546	
Costs and expenses		672	34,268	18,772	153,372	(216)	206,868
Operating income		(672)	27,969	10,788	18,593		56,678
Equity earnings		45,839	190	21,913	30,630	(97,031)	1,541
Interest and other expense, net			(7,536)	(6,534)	(1,245)		(15,315)
Income from continuing operations before income tax expense		45,167	20,623	26,167	47,978	(97,031)	42,904
Income tax expense					2,147		2,147
Income from continuing operations		45,167	20,623	26,167	45,831	(97,031)	40,757
Income from discontinued operations				3,133	1,277		4,410
Net income	\$	\$ 45,167	\$ 20,623	\$ 29,300	\$ 47,108	\$ (97,031)	\$ 45,167

**Condensed Consolidating Statements of Income****For the Nine Months Ended September 30, 2005****(Thousands of Dollars)**

	<b>Valero L.P.</b>	<b>Valero Logistics Operations, L.P.</b>	<b>Kaneb Pipe Line Operating Partnership L.P.</b>	<b>Non- Guarantor Subsidiaries</b>	<b>Eliminations</b>	<b>Valero L.P. Consolidated</b>	
Revenues	\$	\$ 177,179	\$ 29,560	\$ 172,303	\$ (555)	\$ 378,487	
Costs and expenses		1,304	99,415	18,772	153,849	(555)	272,785