An Oil Watchdog Report
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Summary: California has been a gold mine for San Antonio-based Valero energy.

A review of profit, shareholder and government reports from the last decade show that Valero reaped extraordinary profits from its refining operations in the Golden State, while drivers emptied their wallets to fund this refiner bonanza.

In this report by Oil Watchdog, a project of the nonprofit, nonpartisan Consumer Watchdog, we find:

- Valero's refining margins in California have been 37% higher than those at its refineries in other regions of the U.S.
- Profits have been highest in California for the company during periods of steadily rising gasoline prices.
- Higher than average gasoline prices in the West, created by artificially low supplies during periods of high demand, has been Valero's recipe for big profits.
- Valero's future Gold Rush profits depend on higher gasoline prices and less competition from a greener market, explaining its funding of Proposition 23 on the November California ballot.

Valero Energy and Its California Profit Pipeline

Introduction

Valero Energy, a San Antonio, Texas-based refining and gasoline retail company, is among the top five oil refiners in California, but is not a household name like Chevron or BP. However, as Valero becomes a political force in California, residents should know more about its history and high profits reaped from the state.

Valero has emerged as the largest contributor to Proposition 23 on the November ballot in California. The measure would suspend—and in effect revoke—the state's landmark law cutting air pollution and global warming emissions. Valero, as of Oct. 7,[1] has contributed $4.05 million--more than twice the amount of the next largest funder of the initiative (Tesoro, another Texas-based refining company).

Unlike large integrated oil companies such as Chevron or Exxon, Valero does not extract or sell crude oil. Its profits depend on how much more than the cost of oil it can reap for refining and selling its finished gasoline, diesel fuel and other products.

Valero's incentive is to keep gasoline and other fuel prices as high above the price of crude oil as possible, while spending as little as possible to make gasoline. Valero makes its biggest profits during periods when gasoline prices are high and supply is most limited. Historically in California, these margins far exceed national margins.

A 2003 report by then-Atty. Gen. Bill Lockyer blasted California refiners for "exorbitantly high gas prices," caused by supply restrictions that boosted refining margins by 152% over just 3 months.[2] A lawsuit in the 1990s, revived by a California court last year, explicitly cited refiner price-gouging through restriction of supply.[3] A 2007 report by Consumer Watchdog[4] found similar gouging tactics in the mid-2000s.

Valero, more than integrated oil companies like Chevron, depends on revival of such high California refining margins. Any state policy that encourages lower-mileage vehicles and less consumption, or increases Valero's costs to offset pollution, could disrupt this "California Gold" for Valero.

Since Valero bought its second refinery in California in 2002, its per-barrel net refining margins in California have averaged 37% higher than those at its refineries in other regions of the U.S.[5]

In the same time period, Valero's total operating profit from refining in California has totaled $4.5 billion[6] – mostly reaped as gasoline prices and refining profits rose steadily from 2003 to 2007. These profits are estimated to be twice or more what Valero paid for both of its California refineries.[7]

After the U.S. recession hit in 2008, Valero shut down one large refinery in Aruba, sold another in Delaware and has agreed to sell a third in New Jersey. But it is holding onto its California

refineries. Valero is betting that it will once again be able push gasoline prices higher by tightening supplies and the company's California Gold Rush profits will return.

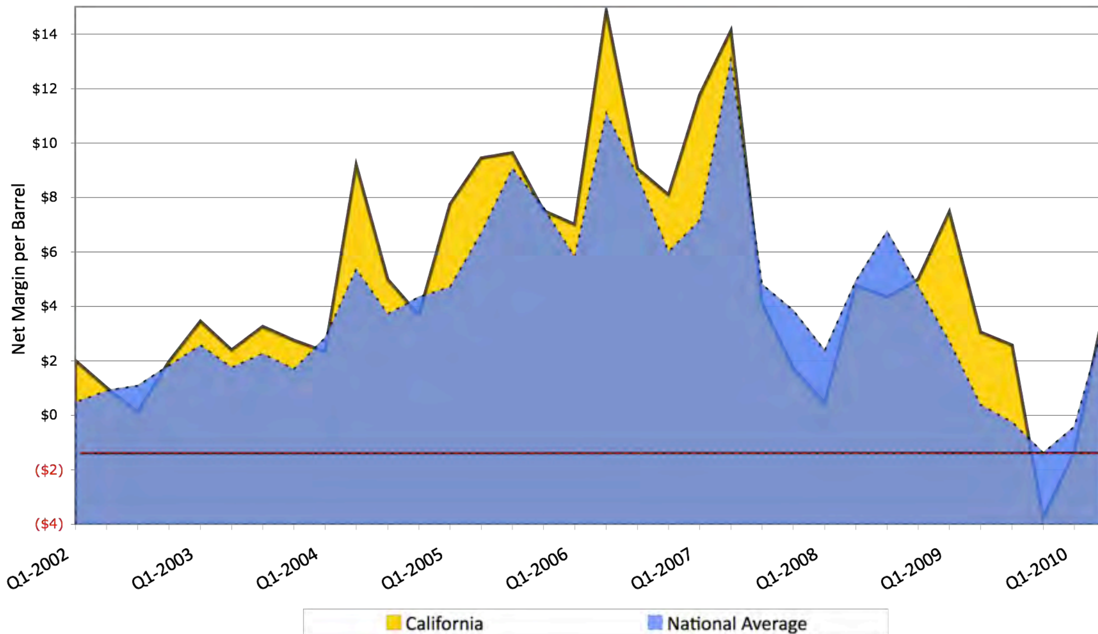
Valero's return to high California profits, however, largely depends on reversing the decline in gasoline consumption and curbing ample inventories in the state, enabling a return to the price gouging of the mid-2000s.

The California Profit Machine

After Valero obtained its second California refinery in Wilmington, its business model of buying relatively bargain-priced refineries and building branded retail gasoline sales in the state began paying off in a huge way. Its operating profit on its two California refineries topped $1 billion[9] in 2006, helping Valero stock reach a new high of $69, more than 10 times the company's value when it bought the Wilmington plant in 2002.

Its higher refining margins in California overrode the higher operating costs of its refineries in California, even in comparison to Valero's much larger and more efficient refineries on the Gulf Coast. In most quarters since 2002, and even during parts of the recession, the company's net margin per barrel from its California refineries exceeded the company's average margin companywide (Figure 1 below, underlying data linked at end of report).

Figure 1: Valero's California Profits Per Barrel Higher Than Company Average



Source: Valero Financial Reports 2002-2010 Note: Since Valero's only refineries in West Coast region are in California, Valero's "West Coast" refinery data are reported here as "California" data

Valero profited handsomely on its bargain-priced refineries as gasoline consumption and prices rose in California from 2002 to 2007. But it crashed harder than other refiners in the recession, as crude oil prices rose to historic highs, consumption steadily dropped and gasoline supplies grew faster than refiners could cut production. The California premium was no longer dependable.

Valero's refineries also had relatively high operating costs, making the high gasoline prices even more important to Valero than other refiners. Petroleum analyst James Shell summed up Valero's business issues in May: [10]

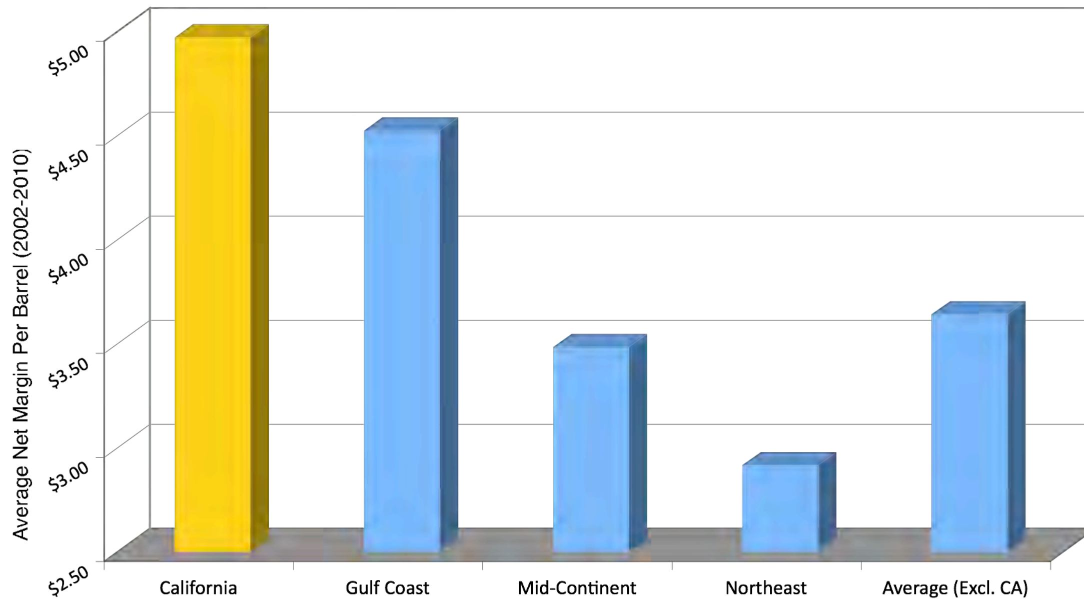
"Valero's production cost, per their financials, is usually between $6.50 and $7 per barrel. Some of the more efficient majors can get their product converted for $5-6, which means that they can stay profitable while [Valero] bleeds money."

Valero has recently shed both of its refineries in the Northeast U.S. petroleum region, shutting and ultimately selling its refinery in Delaware and, in late September, agreeing to sell its larger refinery in New Jersey.

Integrated oil companies like Chevron and Exxon make their money from both selling oil at inflated market prices and by making and selling refined products. Valero, however, buys oil at market prices from the majors. It depends on keeping demand up and supplies low (especially in an isolated market like California) and boosting the differential between the price of crude oil and gasoline as high as possible.

Valero's average gross refining margin in California from 2002 to 2nd quarter 2010, recession and all, was $1.50 to $3 a barrel higher than in other U.S. regions where it was operating. After accounting for the operating costs, Valero reports show its net refining margin in California during this period to be between $0.45 to $2.06 *higher* on each barrel than its net in other regions. The California bonus profit pushed Valero's net margin on refining in California 37% higher than the average in other regions from 2002 to 2010 (See Figure 2 below, underlying data linked at end of report).

Figure 2: Valero's California Refining 37% More Profitable Per Barrel Than Other Regions

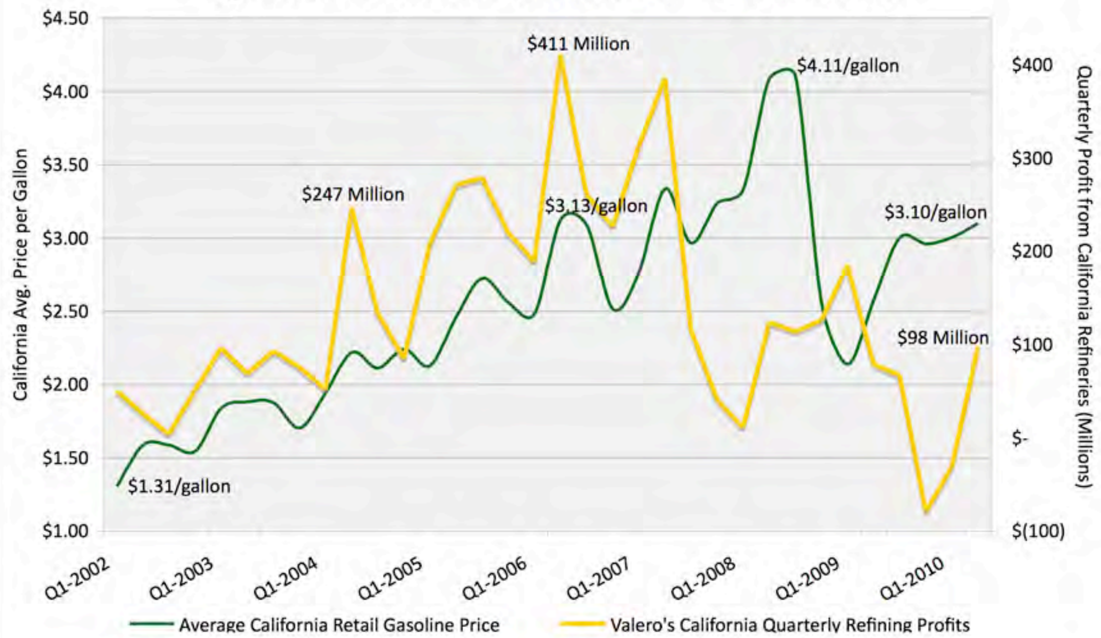


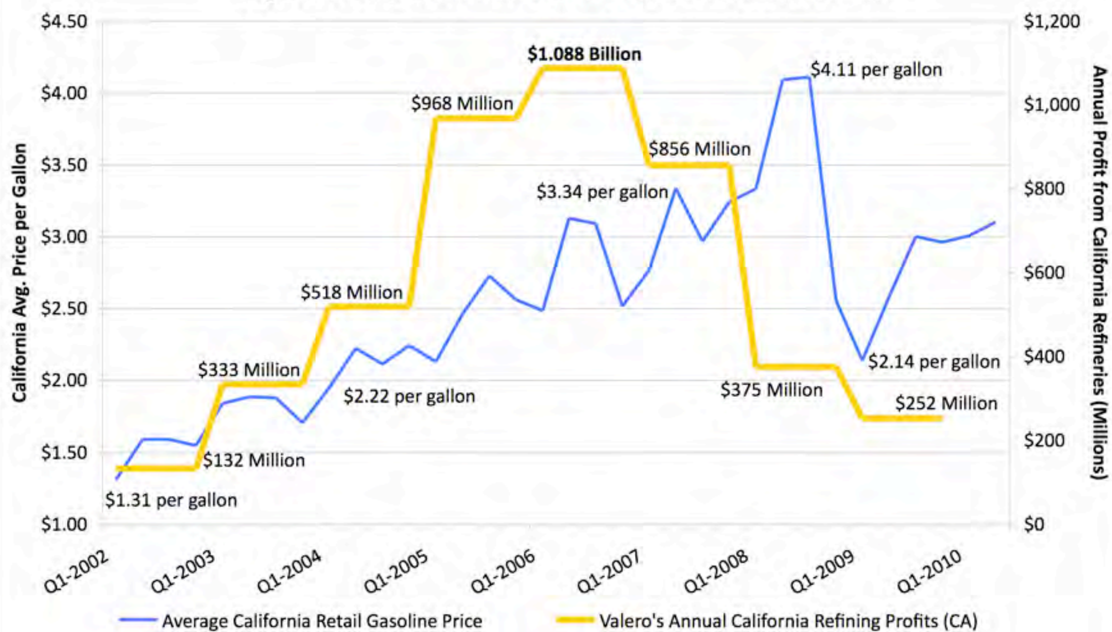
Source: Valero Financial Reports 2002-2010 Note: Since Valero's only refineries in West Coast region are in California, Valero's "West Coast" refinery data are reported here as "California" data

Valero Profits as California Drivers Struggle

California gasoline prices began a steady rise in 2002, rising from $1.31 a gallon at the pump to $4.11 a gallon at their peak in 2008. For most of that period, Valero profited handsomely from drivers' pain, with its California refining profits peaking in 2006 at more than $1 billion from the state. It was only Californians' early and steep cuts in gasoline consumption that finally cut into refining margins.

Valero's California refining profits bottomed in late 2009, but rising gasoline prices (including prices over $3.00 a gallon in California), boosted profits in the 2nd quarter of 2010. The company's stake in the California bonus was reaffirmed. (See Figures 3, with quarterly profits, and 4, with annual profits, below and underlying data linked at end of report[12]).





Conclusion

For most of the past decade, California has been a gold mine for Texas-based Valero, which reaped extremely high refining profits funded by higher-than-the-nation gasoline prices in California. Tougher emission regulations or penalties for emissions could curb a return to the high-price, high-profit model. Fuel prices could also be curbed if new rules reduced demand for refined petroleum products, for instance through rebates for more efficient cars.

Valero's high profitability in California depends on regaining and keeping high refining margins in the state, which requires weak regulation of the industry and steadily increasing gasoline consumption by California drivers. As the public hears more from Valero through its political campaigns, it is important to understand this company's role in California's long struggle with unbearably high fuel prices, and its history of squeezing big profits by gouging California motorists.

For more information about Valero and the oil industry, visit www.OilWatchdog.org.

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[1] California Secretary of State website, Campaign Finance, "Yes on 23" http://cal-access.sos.ca.gov/Campaign/Committees/Detail.aspx?id=1323890&session=2009&view=late1

[2] "Attorney General Lockyer Releases Data Showing Fast-Rising Profit Margins for State's Gas Refiners," Sept. 3, 2003. News release with links:
http://ag.ca.gov/newsalerts/release.php?id=1145

[3] Ronald D. White, Los Angeles Times, "Suit Over Gas Pricing Revived," April 9, 2003.
[4] T. Hamilton and J. Dugan, "The Katrina Syndrome," for Consumer Watchdog. July 23, 2007.
http://www.oilwatchdog.org/wp-content/uploads/2010/09/KatrinaLessons2007.pdf

[5] Valero's two refineries in California are in Benicia, which has a refining capacity of about 144,000 barrels of oil per day and in Wilmington, which can refine 80,000 barrels a day, per 2008 estimates by the California Energy Commission. Valero lists Benicia at 170,000 BPD capacity and Wilmington at 135,000 BPD including an associated asphalt plant that the CEC lists separately.
[6] Valero 10-k reports, 2002-2008:
Operating Income from West Coast refining operations, in millions
Since Valero only has West Coast refineries in CA, its reference to "West Coast" is in effect the two Valero refineries in CA.

Year	
2002	$132.5
2003	$333.8
2004	$518.4
2005	$968.0
2006	$1,088.0
2007	$856.0
2008	$375.0

2009	$252.0
Total	$4,523.7
Yearly average	$565.5

[7] Valero paid $895 million to Exxon for the Benicia refinery and 340 branded gas stations (http://www.allbusiness.com/retail-trade/food-stores/4491617-1.html). Valero completed acquisition of its Wilmington refinery in 2002 with the purchase of Ultramar Diamond Shamrock for $4.1 billion and acceptance of $2 billion in debt. The deal included six refineries and 2,000 company-owned gas stations. (http://www.secinfo.com/drDX9.4f8Rc.htm)Valero spun off Golden Eagle, the larger of Ultramar's two California refineries, for $1.1 billion. (http://www.bizjournals.com/eastbay/stories/2002/04/22/story4.html) The estimated value at the time of its Wilmington refinery would be similar.

[9] See chart in footnote 6

[10] James Shell, Seeking Alpha website, "Valero, Refining Margins and Making Money," May 27, 2010. http://seekingalpha.com/article/207257-valero-refining-margins-and-making-money

[12] The underlying data for Figures 1-4 can be downloaded at http://www.ConsumerWatchdog.org/resources/ValeroProfitPipelineData.xls