

VALERO GP HOLDINGS LLC
Form 10-Q
November 08, 2006

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, 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 1-32940

VALERO GP HOLDINGS, LLC

(Exact name of registrant as specified in its charter)

Delaware

(State or other jurisdiction of
incorporation or organization)

85-0470977

(I.R.S. Employer
Identification No.)

One Valero Way

San Antonio, Texas

(Address of principal executive offices)

78249

(Zip Code)

For the quarterly period ended September 30, 2006

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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 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

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

The number of units outstanding as of November 1, 2006 was 42,500,000.

VALERO GP HOLDINGS, LLC AND SUBSIDIARIES

FORM 10-Q

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PART I FINANCIAL INFORMATION**Item 1. Financial Statements**

VALERO GP HOLDINGS, LLC
CONSOLIDATED BALANCE SHEETS
(Thousands of Dollars)

	September 30, 2006 (Unaudited)	December 31, 2005
Assets		
Current assets:		
Cash	\$ 1,116	\$ 121
Receivable from Valero L.P.	11,089	1,151
Receivable from Valero Energy.	1,092	
Income taxes receivable.	227	
Total current assets	13,524	1,272
Investment in Valero L.P.	561,235	408,744
Long-term receivable from Valero L.P.	5,812	
Deferred tax asset	1,174	298
Total assets	\$ 581,745	\$ 410,314
Liabilities and Members Equity		
Current liabilities:		
Accounts payable	\$ 98	\$ 2
Payable to Valero Energy	9,226	
Income taxes payable		11
Accrued liabilities	1,993	2,560
Total current liabilities	11,317	2,573
Long-term debt	1,000	
Notes payable to affiliates		265,961
Other long-term liabilities	9,695	
Members equity	559,733	141,780
Total liabilities and members equity	\$ 581,745	\$ 410,314

See Condensed Notes to Consolidated Financial Statements.

VALERO GP HOLDINGS, LLC

CONSOLIDATED STATEMENTS OF INCOME

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

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Equity in earnings of Valero L.P.	\$ 11,637	\$ 12,203	\$ 32,141	\$ 29,543
General and administrative expenses	(877)		(903)	(16)
Other expense, net	(286)	5	(249)	447
Interest income affiliated		36	53	73
Interest expense affiliated	(901)	(4,417)	(10,368)	(13,293)
Interest and debt expense	(6)		(6)	
Income before income tax expense	9,567	7,827	20,668	16,754
Income tax expense (benefit)	(130)	21	273	65
Net income	\$ 9,697	\$ 7,806	\$ 20,395	\$ 16,689
Basic net income per unit	\$ 0.23	\$ 0.18	\$ 0.48	\$ 0.39
Weighted average number of basic units outstanding	42,500,000	42,500,000	42,500,000	42,500,000
Diluted net income per unit	\$ 0.23	\$ 0.18	\$ 0.48	\$ 0.39
Weighted average number of diluted units outstanding	42,500,626	42,500,000	42,500,211	42,500,000

See Condensed Notes to Consolidated Financial Statements.

VALERO GP HOLDINGS, LLC
CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited, Thousands of Dollars)

	Nine Months Ended	
	September 30, 2006	2005
Cash Flows from Operating Activities:		
Net income	\$ 20,395	\$ 16,689
Adjustments to reconcile net income to net cash provided by operating activities:		
Equity in earnings of Valero L.P.	(32,141)	(29,543)
Distributions of equity income from Valero L.P.	32,141	29,543
Loss (gain) on sale of Valero L.P. units in connection with employee benefit plans	249	(447)
Provision for deferred income taxes	100	(151)
Changes in current assets and liabilities:		
Increase in receivable from Valero L.P.	(10,291)	(31)
Increase in receivable from Valero Energy	(72)	
Increase in income taxes receivable.	(227)	
Increase in payable to Valero Energy	9,820	
Decrease in accounts payable and accrued liabilities	(481)	
Increase (decrease) in other long-term liabilities	1,838	(684)
Other	2	
Net cash provided by operating activities	21,333	15,376
Cash Flows from Investing Activities:		
Distributions in excess of equity in earnings of Valero L.P.	7,408	2,533
Contribution to Valero L.P.	(1,636)	(29,748)
Proceeds from sale of Valero L.P. units in connection with employee benefit plans	1,812	2,797
Net cash provided by (used in) investing activities	7,584	(24,418)
Cash Flows from Financing Activities:		
Increase (decrease) in notes payable to affiliates	689	(10,925)
Long-term debt borrowings	1,000	
Contributions from Valero Energy		29,199
Distributions to Valero Energy	(29,611)	(9,231)
Net cash provided by (used in) financing activities	(27,922)	9,043
Net increase in cash	995	1
Cash at the beginning of the period	121	120
Cash at the end of the period	\$ 1,116	\$ 121
Supplemental cash flow information:		
Cash paid during the period for interest	\$ 10,368	\$ 13,293
Cash paid during the period for income taxes	\$ 37	\$

See Condensed Notes to Consolidated Financial Statements.

VALERO GP HOLDINGS, LLC

CONDENSED NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION, BASIS OF PRESENTATION AND SIGNIFICANT ACCOUNTING POLICIES

Organization

Valero GP Holdings, LLC (Valero GP Holdings), a Delaware limited liability company, was formed in June 2000 as UDS Logistics, LLC (UDS Logistics). Valero Energy Corporation (Valero Energy) (NYSE: VLO), a publicly held independent refining and marketing company, acquired UDS Logistics in connection with its December 31, 2001 acquisition (UDS Acquisition) of Ultramar Diamond Shamrock Corporation (UDS). UDS Logistics changed its name to Valero GP Holdings in January 2006. On July 19, 2006, our existing membership interests consisted of 10,000,000 units representing limited liability company interests, and a 4.25-for-1 unit split was effected, resulting in 42,500,000 total units outstanding, all of which were owned by Valero Energy and its subsidiaries, maintaining their pre-split ownership percentages. Immediately subsequent to the unit split, certain subsidiaries of Valero Energy sold 17,250,000 units of Valero GP Holdings (NYSE: VEH) in an initial public offering (IPO) for a price to the public of \$22.00 per unit. We did not receive any proceeds from the IPO. Subsequent to the IPO, subsidiaries of Valero Energy owned 25,250,000 units or approximately 59% of our outstanding units.

As used in this report, references to we, us, or our collectively refer, depending on the context, to Valero GP Holdings, LLC or a wholly owned subsidiary.

On January 25, 2006, Valero GP Holdings formed a wholly owned subsidiary, Riverwalk Holdings, LLC (Riverwalk Holdings), and Valero GP Holdings contributed its 99.9% limited partner interest in Riverwalk Logistics, L.P. (Riverwalk Logistics) and its subordinated units and common units of Valero L.P. to Riverwalk Holdings.

On June 1, 2006, Valero Energy contributed its ownership interest in Valero GP, LLC to Valero GP Holdings in exchange for an additional ownership interest in Valero GP Holdings. As a result, Valero GP, LLC, Riverwalk Logistics, and Riverwalk Holdings are wholly owned subsidiaries of Valero GP Holdings.

On September 30, 2006, Valero GP Holdings owned approximately 23.4% of Valero L.P., consisting of the following:

- the 2% general partner interest in Valero L.P.;
- 100% of the incentive distribution rights issued by Valero L.P., which entitles us to receive increasing percentages of the cash distributed by Valero L.P., currently at the maximum percentage of 23%; and
- 10,219,282 common units of Valero L.P. representing a 21.4% limited partner interest in Valero L.P.

Valero L.P. (NYSE: VLI) is a publicly traded Delaware limited partnership engaged in the crude oil and refined product transportation, terminalling and storage business. Valero L.P. has terminal facilities in the United States, the Netherland Antilles, Canada, Mexico, the Netherlands and the United Kingdom.

Basis of Presentation

These unaudited consolidated financial statements include the accounts of Valero GP Holdings and subsidiaries in which it has a controlling interest. Intercompany balances and transactions have been eliminated in consolidation. Prior to June 1, 2006, these financial statements combined the consolidated financial statements of Valero GP Holdings with the financial statements of Valero GP, LLC. The consolidated financial statements of Valero GP Holdings included the financial statements of Riverwalk Logistics and Riverwalk Holdings. Intercompany transactions and balances between the combined companies have been eliminated.

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We account for our ownership interest in Valero L.P. using the equity method. Therefore, our financial results reflect a portion of Valero L.P.'s net income based on our ownership interest in Valero L.P. We have no separate operating activities apart from those conducted by Valero L.P. and therefore generate no revenues from operations.

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

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recurring nature unless disclosed otherwise. Financial information for the three and nine months ended September 30, 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 and nine months ended September 30, 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 Valero GP Holdings' registration statement on Form S-1, as amended.

Significant Accounting Policy

Securities and Exchange Commission (SEC) Staff Accounting Bulletin No. 51, Accounting for Sales of Stock by a Subsidiary (SAB 51), provides guidance on accounting for the effect of issuances of a subsidiary's stock on the parent's investment in that subsidiary. SAB 51 allows registrants to elect an accounting policy of recording such increases or decreases in a parent's investment (SAB 51 credits or charges, respectively) either in income or in equity. In accordance with the election provided in SAB 51, we adopted a policy of recording such SAB 51 credits or charges directly to members' equity.

2. ACCOUNTING PRONOUNCEMENTS

EITF Issue No. 04-5

In June 2005, the Financial Accounting Standards Board (FASB) ratified its consensus on Emerging Issues Task Force (EITF) Issue No. 04-5, Determining Whether a General Partner, or the General Partners as a Group, Controls a Limited Partnership or Similar Entity When the Limited Partners Have Certain Rights (EITF No. 04-5), which requires the general partner in a limited partnership to determine whether the limited partnership is controlled by, and therefore should be consolidated by, the general partner. The guidance in EITF No. 04-5 was effective after June 29, 2005 for general partners of all new partnerships formed and for existing limited partnerships for which the partnership agreements are modified. For general partners in all other limited partnerships, the guidance in EITF No. 04-5 was effective no later than January 1, 2006. We adopted EITF No. 04-5 effective January 1, 2006, the adoption of which had no impact on the accounting for our investment in Valero L.P.

FASB Interpretation No. 48

In June 2006, the FASB issued Interpretation No. 48, Accounting for Uncertainty in Income Taxes—an interpretation of FASB Statement No. 109 (FIN 48). FIN 48 clarifies the accounting for uncertain income tax positions recognized in an enterprise's financial statements in accordance with FASB Statement No. 109, Accounting for Income Taxes, by defining a recognition threshold and measurement attribute for the financial statement recognition and measurement of a tax position taken or expected to be taken in a tax return. An enterprise recognizes a tax position if it is more-likely-than-not that the tax position will be sustained, based on the technical merits of the position, upon examination. An uncertain tax position is measured in the financial statements at the largest amount of benefit that is more-likely-than-not to be realized. FIN 48 is effective for fiscal years beginning after December 15, 2006 and we are continuing to evaluate its effect on our financial position or results of operations.

FASB Statement No. 157

In September 2006, the FASB issued Statement No. 157, Fair Value Measurements. Statement No. 157 defines fair value, establishes a framework for measuring fair value under GAAP, and expands disclosures about fair value measures. Statement No. 157 is effective for fiscal years beginning after November 15, 2007, with early adoption encouraged. The provisions of Statement No. 157 are to be applied on a prospective basis, with the exception of certain financial instruments for which retrospective application is required. The adoption of Statement No. 157 is not expected to materially affect our financial position or results of operations.

FASB Statement No. 158

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In September 2006, the FASB issued Statement No. 158, *Employers' Accounting for Defined Benefit and Other Postretirement Plans*, which amends Statement No. 87, *Employers' Accounting for Pensions*, Statement No. 88, *Employers' Accounting for Settlements and Curtailments of Defined Benefit Pension Plans and for Termination Benefits*, Statement No. 106, *Employers' Accounting for Postretirement Benefits Other Than Pensions*, Statement No. 132 (revised 2003), *Employers' Disclosures about Pensions and Other Postretirement Benefits* and other related accounting literature.

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Statement No. 158 requires an employer to recognize the overfunded or underfunded status of a defined benefit postretirement plan as an asset or a liability in the statement of financial position and to recognize changes in that funded status through comprehensive income in the year the changes occur. This statement also requires an employer to measure the funded status of a plan as of the date of the employer's year-end statement of financial position. The funded status recognition and related disclosure requirements of Statement No. 158 are effective for us as of the end of the fiscal year ending after December 15, 2006. The requirement to measure plan assets and benefit obligations as of the date of the employer's year-end statement of financial position is effective for fiscal years ending after December 15, 2008. Earlier application of the recognition or measurement date provisions is encouraged. We are currently evaluating the impact of Statement No. 158 on our financial position.

3. INVESTMENT IN VALERO L.P.

As of September 30, 2006 and December 31, 2005, we owned 23.4% of Valero L.P., which was composed of a 2% general partner interest, incentive distribution rights and a 21.4% limited partner interest in Valero L.P. Valero L.P. has issued common units to the public on three separate occasions, which has diluted our ownership percentage. These three issuances have resulted in increases (or credits) in our proportionate share of Valero L.P.'s capital because, in each case, the issuance price per unit exceeded our carrying amount per unit at the time of issuance. We had not recognized any SAB 51 credits in our consolidated financial statements through March 31, 2006 and were not permitted to do so until our subordinated units converted to common units. In conjunction with the conversion of the subordinated units held by us into common units in the second quarter, we recognized the entire balance of \$158.2 million in SAB 51 credits as an increase in our investment in Valero L.P. and an increase to members' equity.

Summary Financial Information

Condensed financial information reported by Valero L.P. is summarized below:

	September 30, 2006 (Thousands of Dollars)	December 31, 2005
Balance Sheet Information:		
Current assets	\$ 201,599	\$ 295,411
Property and equipment, net	2,172,582	2,160,213
Goodwill	774,966	767,587
Other long-term assets, net	151,395	143,781
Total assets	\$ 3,300,542	\$ 3,366,992
Current liabilities	\$ 138,618	\$ 205,588
Long-term debt, less current portion	1,178,476	1,169,659
Other long-term liabilities	96,777	90,966
Total liabilities	1,413,871	1,466,213
Partners' equity	1,886,671	1,900,779
Total liabilities and partners' equity	\$ 3,300,542	\$ 3,366,992

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
	(Thousands of Dollars)			
Statement of Income Information:				
Revenues	\$ 291,023	\$ 258,385	\$ 844,995	\$ 373,326
Operating income	54,380	56,007	157,663	105,031
Net income	41,169	45,167	112,173	83,283

Other

As of September 30, 2006 and December 31, 2005, our investment in Valero L.P. (representing both the 2% general partner interest and the 21.4% limited partner interest) reconciles to Valero L.P.'s total partners' equity as follows:

	September 30, 2006 (Thousands of Dollars)		December 31, 2005	
Valero L.P. total partners' equity	\$ 1,886,671		\$ 1,900,779	
Valero GP Holdings' ownership interest in Valero L.P.	23.4	%	23.4	%
Valero GP Holdings' share of Valero L.P.'s partners' equity	441,481		444,782	
Unrecognized SAB 51 credits			(158,170)
Step-up in basis related to Valero L.P.'s assets and liabilities, including equity method goodwill, and other	119,754		122,132	
Investment in Valero L.P.	\$ 561,235		\$ 408,744	

The step-up in basis related to Valero L.P.'s assets and liabilities, including equity method goodwill, reflected in the table above relates to purchase accounting adjustments resulting from Valero Energy's UDS Acquisition. The amount represents the unamortized excess of the fair value over carrying amount applicable to Valero Energy's proportionate 73.6% interest in Valero L.P.'s identifiable assets and liabilities as of December 31, 2001. This amount also includes the portion of goodwill resulting from the UDS Acquisition that was attributed to Valero GP Holdings' investment in Valero L.P. Since 26.4% of the equity interest in Valero L.P. was owned by public unitholders as of the date of the UDS Acquisition, a significant portion of the total ownership interest in Valero L.P. was deemed to be held by the public under generally accepted accounting principles, thereby precluding the inclusion of these fair value adjustments in the reported financial statements of Valero L.P.

4. RELATED PARTY TRANSACTIONS**Relationships**

We manage Valero L.P. through our ownership of Valero GP, LLC, and Riverwalk Holdings, which own Riverwalk Logistics, the general partner of Valero L.P. Our officers are also officers of Valero GP, LLC. The Chairman of our Board of Directors, William E. Greehey, is also the Chairman of the Board of Directors of Valero GP, LLC and Valero Energy. The Board of Directors of Valero GP, LLC is responsible for overseeing Valero GP, LLC's role as the owner of the general partner of Valero L.P., and we, as the sole owner of Valero GP, LLC, must also approve matters that have or would reasonably be expected to have a material effect on our interests as the sole owner of Valero GP, LLC.

Valero GP, LLC provides employee services to Valero L.P. to perform operating and maintenance services with respect to Valero L.P. assets for which Valero GP, LLC receives reimbursement from Valero L.P. In addition, subsidiaries of Valero Energy, other than Valero GP Holdings or Valero GP, LLC, provide administrative services for which an annual fee is charged to Valero L.P. Effective January 1, 2006, the services agreement was amended and now provides for fewer services by Valero Energy subsidiaries due to the transfer to Valero GP, LLC of a substantial number of Valero Energy employees who had previously provided services to Valero L.P. under the prior services agreement. For purposes of these financial statements, for the period prior to the initial public offering, no corporate costs have been allocated to Valero GP Holdings by Valero Energy as management has determined that no such corporate costs were incurred specifically on behalf of Valero GP Holdings.

As of September 30, 2006 and December 31, 2005, Valero GP Holdings had a receivable from Valero L.P. of \$11.1 million and \$1.2 million, respectively, with both amounts representing payroll and related benefit plan costs for employees. Valero GP Holdings also has a long-term receivable of \$5.8 million from Valero L.P. related to amounts payable for retiree medical benefits and other post-employment benefits.

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The following table summarizes the results of transactions with Valero L.P.:

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Expenses charged by Valero GP Holdings to Valero L.P.	\$ 29,155	\$ 24,350	\$ 80,625	\$ 44,701

Administration Agreement

On July 19, 2006, in connection with the IPO, Valero GP Holdings entered into an administration agreement with Valero GP, LLC (the Administration Agreement). The Administration Agreement provides, among other things, that Valero GP, LLC will provide all executive management and other administrative services to Valero GP Holdings. Valero GP Holdings does not have any employees.

Valero GP Holdings will pay annual charges under the Administration Agreement of \$0.5 million to Valero GP, LLC. This amount will be increased annually to reflect Valero GP, LLC's annual merit increases. Any other adjustments to the annual fee, such as adjustments to reflect changes in the levels of service provided to Valero GP Holdings or Valero GP, LLC's actual payroll cost, are subject to the approval of Valero GP, LLC's conflicts committee. Valero GP Holdings will also reimburse Valero GP, LLC for all direct public company costs and any other direct costs, such as outside legal and accounting fees, that Valero GP, LLC incurs while providing services to Valero GP Holdings pursuant to the Administration Agreement.

The Administration Agreement will terminate on December 31, 2011, with automatic two-year renewals unless terminated by either party on six months' written notice. Valero GP Holdings may cancel or reduce the services provided under the Administration Agreement on 60 days' written notice. The Administration Agreement will terminate upon a change of control of either Valero GP Holdings or Valero GP, LLC. Valero GP, LLC's conflicts committee has approved the terms of the Administration Agreement.

2006 Omnibus Agreement

On March 31, 2006, Valero L.P. entered into an amended and restated omnibus agreement (the 2006 Omnibus Agreement) by and among Valero L.P., Riverwalk Logistics, Valero Energy, Valero GP, LLC, and Valero Logistics Operations, L.P., a wholly owned subsidiary of Valero L.P. The conflicts committee of the board of directors of Valero GP, LLC approved the terms of the 2006 Omnibus Agreement on March 10, 2006. The 2006 Omnibus Agreement supersedes the omnibus agreement among the parties dated effective April 16, 2001.

Under the 2006 Omnibus Agreement, Valero Energy has agreed, and will cause its controlled affiliates, including us, to agree 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 for so long as Valero Energy or its controlled affiliates owns 20% or more of Valero L.P. or Riverwalk Logistics. This restriction does not apply to:

- any business retained by UDS as of April 16, 2001, the closing of Valero L.P.'s initial public offering, or any business owned by Valero Energy at the date of the UDS Acquisition;
 - 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 Valero L.P. has been offered and declined the opportunity to purchase the business;
- and

- any newly constructed pipeline, terminalling or storage assets that Valero L.P. has not offered to purchase at fair market value within one year of construction.

Also under the 2006 Omnibus Agreement, Valero Energy has agreed to indemnify Valero L.P. for environmental liabilities related to the assets transferred to Valero L.P. in connection with Valero L.P.'s 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).

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Non-Compete Agreement

On July 19, 2006, in connection with the IPO, we entered into a non-compete agreement with Valero L.P., Riverwalk Logistics, and Valero GP, LLC (the Non-Compete Agreement). The Non-Compete Agreement will become effective when we are no longer subject to the 2006 Omnibus Agreement described above. Under the Non-Compete Agreement, we will have a right of first refusal with respect to the potential acquisition of general partner and other equity interests in publicly traded partnerships under common ownership with the general partner interest. Valero L.P. will have a right of first refusal with respect to the potential acquisition of assets that relate to the transportation, storage or terminalling of crude oil, feedstocks or refined petroleum products (including petrochemicals) in the United States and internationally. With respect to any other business opportunities, neither we nor Valero L.P. are prohibited from engaging in any business, even if we and Valero L.P. would have a conflict of interest with respect to such other business opportunity. The Non-Compete agreement remains in effect for so long as Valero GP Holdings or any of its affiliates own 20% or more of Valero GP, LLC or Riverwalk Logistics.

Employee Benefits Transition Agreement

On October 13, 2006, Valero GP Holdings entered into an Employee Benefits Transition Agreement effective as of July 1, 2006 (the Transition Agreement). Prior to July 1, 2006, the employees of Valero GP, LLC were included in the various employee benefit plans of Valero Energy. These plans include a defined benefit pension plan, a retiree welfare benefit plan, health and welfare benefits, a defined contribution retirement plan, equity incentive plans and nonqualified deferred compensation plans. In accordance with the Transition Agreement and in connection with the initial public offering on July 19, 2006, employees of Valero GP, LLC began participating in newly enacted, comparable plans sponsored by Valero GP, LLC.

In connection with this transition, Valero Energy and certain of its subsidiaries transferred related liabilities and assets totaling \$7.9 million to Valero GP Holdings. In addition, Valero Energy, at its cost and expense, agreed to assist Valero GP, LLC in the design, preparation and initial implementation of Valero GP, LLC's employee benefit plans. Under the Transition Agreement, Valero Energy will continue to provide the transition services and arrangements described therein through the earlier of the completion of such services and arrangements or the effective date of the final sale by Valero Energy of its remaining membership interest in Valero GP Holdings, unless the parties otherwise agree.

Notes Payable to Affiliates

Our notes payable to affiliates (the Notes) reflected the allocation to us of a portion of the debt incurred by Valero Energy to fund the UDS Acquisition, as well as the effect of cash inflows and outflows resulting from our normal operations. Effective July 19, 2006, in conjunction with the initial public offering, Valero Energy made a capital contribution to us of the outstanding balance of the Notes, including accrued interest.

5. DISTRIBUTIONS FROM VALERO L.P.

Valero L.P.'s partnership agreement, as amended, determines the amount and priority of cash distributions that Valero L.P.'s common unitholders and general partner may receive. The general partner is entitled to incentive distributions if the amount Valero L.P. distributes with respect to any quarter exceeds \$0.60 per unit, with the maximum percentage of 23% of the amount of any quarterly distribution in excess of \$0.66 per unit. The general partner also receives a 2% distribution with respect to its general partner interest.

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The following table reflects the allocation of Valero L.P.'s cash distributions earned for the period indicated among its general and limited partners:

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
	(Thousands of Dollars, Except Per Unit Data)			
General partner interest (2%)	\$ 955	\$ 879	\$ 2,787	\$ 2,157
General partner incentive distribution	3,909	3,049	10,869	7,210
Total general partner distribution	4,864	3,928	13,656	9,367
Valero GP Holdings' limited partner distribution	9,350	8,740	27,447	25,675
Total distributions to Valero GP Holdings	14,214	12,668	41,103	35,042
Public unitholders' distributions	33,480	31,282	98,237	72,803
Total cash distributions	\$ 47,694	\$ 43,950	\$ 139,340	\$ 107,845
Cash distributions per unit applicable to limited partners	\$ 0.915	\$ 0.855	\$ 2.685	\$ 2.510

On October 26, 2006, Valero L.P. declared cash distributions related to the third quarter of 2006 of \$0.915 per unit to be paid on November 14, 2006 to unitholders of record on November 7, 2006.

7. CREDIT FACILITY

On July 19, 2006, we entered into a three-year revolving credit facility with a borrowing capacity of up to \$20 million (the Credit Facility). Of the Credit Facility's \$20 million commitment, up to \$10 million may be available for letters of credit. Our obligations under the Credit Facility are unsecured. The Credit Facility contains customary covenants and provisions including limitations on indebtedness, liens, dispositions of material property, mergers and asset transfers. Borrowings under the Credit Facility bear interest, at our option, at either: (i) the higher of (a) JPMorgan Chase Bank, N.A.'s prime rate or (b) the federal funds effective rate plus one-half percent; or (ii) the Eurodollar rate, as adjusted for statutory reserve requirements for Eurocurrency liabilities, plus an applicable margin that varies based upon our credit rating. During the three months ended September 30, 2006, we borrowed \$1.0 million under the Credit Facility, which bears interest at 5.9%. As of September 30, 2006, we had \$19.0 million available for borrowing under the Credit Facility.

Under the terms of the Credit Facility, Valero L.P. must maintain a total debt-to-EBITDA ratio of less than 4.75 to 1.0 for any four consecutive quarters, subject to adjustment following certain acquisitions. We are also required to receive cash distributions of at least \$25.0 million in respect to our ownership interests in Valero L.P. for the preceding four fiscal quarters ending on the last day of each fiscal quarter.

Additionally, the Credit Facility contains customary events of default, including a change in control, that could result in the acceleration of all amounts and cancellation of all commitments outstanding under the Credit Facility. A change in control is defined to mean any of the following events: (i) Valero GP Holdings ceases, indirectly or directly, to own all of the issued and outstanding equity interests of the general partner(s) of Valero L.P., or we no longer have the power, directly or indirectly, to direct or to cause the direction of the management or the policies of Valero L.P.; or (ii) the occurrence of any transaction that results in any person or group, other than Valero Energy or an entity with unsecured senior debt with an investment grade rating, becoming the beneficial owner of more than 50% of our equity interests.

8. COMMITMENTS AND CONTINGENCIES

Litigation and Environmental Matters

We are not currently a party to any material legal proceedings. However, Valero L.P. is subject to certain loss contingencies, the outcome of which could have an effect on Valero L.P.'s results of operations and ability to pay

distributions, which would impact our results of operations and ability to pay distributions. Valero L.P.'s most significant contingent liabilities resulting from various litigation, claims and commitments are discussed below.

Grace Energy Corporation Matter. In 1997, Grace Energy Corporation (Grace Energy) sued subsidiaries of Kaneb in Texas state court. Valero L.P. acquired Kaneb Services LLC (KSL) and Kaneb Pipe Line Partners, L.P. (KPP, and, together with KSL, Kaneb) on July 1, 2005. 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.

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. Valero L.P. owns a chemical and refined products terminal on property owned by the Port of Vancouver, and leases 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 Valero L.P.'s 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. Valero L.P. disputed this assertion. No lawsuits have been filed against Valero L.P. in this matter, and Valero L.P. has not made any payments toward remediation of the allegedly commingled plume. Factors that could affect estimated remediation costs include whether Kaneb will be found to have ultimate responsibility for some portion of the allegedly 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.

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 Valero L.P. 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, Valero L.P. 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, Valero L.P. 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

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amounts otherwise (including settlement of audits) due or potentially due to St. Eustatius. Valero L.P. 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. Valero L.P. 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

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Agreement), Valero L.P. can carry forward that excess to offset future tax liabilities. If the minimum annual profit tax is less than 2% of taxable profit, Valero L.P. agreed to pay that difference.

Other

Valero L.P. is also a party to additional claims and legal proceedings arising in the ordinary course of business. Valero L.P. believes the possibility is remote that the final outcome of any of these claims or proceedings to which they are a party would have a material adverse effect on the Valero L.P. 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 Valero L.P.'s results of operations, financial position or liquidity.

9. MEMBERS EQUITY AND NET INCOME PER UNIT

As discussed previously, on July 19, 2006, our existing membership interests were represented by 10,000,000 units and a 4.25-for-1 unit split was effected, resulting in total outstanding units of 42,500,000 with the members of Valero GP Holdings maintaining their ownership percentages after the unit split. Prior to those transactions, we had no outstanding units. Our net income per unit amounts assume that 42,500,000 units were outstanding for all periods presented.

We calculate basic net income per unit by dividing net income by the weighted average number of units outstanding for the period. Diluted net income per unit is calculated by dividing net income by the weighted average number of units outstanding and the effect of non-vested restricted units granted under the Valero GP Holdings, LLC 2006 Long-Term Incentive Plan calculated using the treasury stock method. Net income per unit amounts were computed as follows (dollars in thousands, except unit data and per unit amounts):

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Basic Net Income per Unit:				
Net income	\$ 9,697	\$ 7,806	\$ 20,395	\$ 16,689
Weighted average number of basic units outstanding	42,500,000	42,500,000	42,500,000	42,500,000
Basic net income per unit	\$ 0.23	\$ 0.18	\$ 0.48	\$ 0.39
Diluted Net Income per Unit:				
Net income	\$ 9,697	\$ 7,806	\$ 20,395	\$ 16,689
Weighted average number of basic units outstanding	42,500,000	42,500,000	42,500,000	42,500,000
Effect of dilutive securities - restricted unit grants	626		211	
Weighted average number of diluted units outstanding	42,500,626	42,500,000	42,500,211	42,500,000
Diluted net income per unit	\$ 0.23	\$ 0.18	\$ 0.48	\$ 0.39

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The following table presents changes to our members' equity (in thousands):

Balance as of December 31, 2005	\$ 141,780
Net income	20,395
Distributions to Valero Energy	(29,611)
Contributions from Valero Energy	267,198
SAB 51 credits	158,170
Share of Valero L.P.'s other comprehensive income	1,801
Balance as of September 30, 2006	\$ 559,733

Comprehensive Income

For the three and nine months ended September 30, 2006, the difference between our net income and our comprehensive income resulted from our proportionate share of Valero L.P.'s other comprehensive income. Our total comprehensive income was as follows:

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
	(Thousands of Dollars)			
Net income	\$ 9,697	\$ 7,806	\$ 20,395	\$ 16,689
Share of Valero L.P.'s other comprehensive income	(24))	1,801	
Comprehensive income	\$ 9,673	\$ 7,806	\$ 22,196	\$ 16,689

Cash Distributions

On October 30, 2006, we declared, for the period from our initial public offering on July 19, 2006 to September 30, 2006, a prorated initial quarterly distribution of \$0.2574 per unit, which is based on a quarterly distribution of \$0.32 per unit. Total cash distributions to be paid for the period from July 19, 2006 to September 30, 2006 are \$10.9 million. The distribution is expected to be paid on November 17, 2006 to holders of record as of November 7, 2006.

The cash distribution to be paid on November 17, 2006 to Valero Energy for the first 18 days of the quarter is \$2.7 million.

Second Amended and Restated Limited Liability Company Agreement

On July 19, 2006, in connection with the IPO, we amended and restated our limited liability company agreement (the Second Amended and Restated Limited Liability Company Agreement). The material provisions of the Second Amended and Restated Limited Liability Company Agreement include the distributions of available cash, rights of unitholders, the election of members of our board of directors and allocations of taxable income and other matters.

We have historically made distributions to Valero Energy affiliates in accordance with our limited liability company agreement, under which cash receipts less cash expenditures are distributed on a quarterly or more frequent basis to our members. The Second Amended and Restated Limited Liability Company Agreement requires that, within 50 days after the end of each quarter beginning with the quarter ending September 30, 2006, we distribute all of our available cash to the holders of record of our units on the applicable record date. Available cash is defined as all cash on hand at the end of any calendar quarter less the amount of cash reserves necessary or appropriate, as determined in good faith by our board of directors.

Rights Agreement

On July 19, 2006, we entered into a rights agreement with Computershare Investor Services, LLC (the Rights Agreement) under which one preferred unit purchase right (Right) is attached to each of our outstanding units. The Rights become exercisable under specified circumstances, including any person or group (an acquiring person) becoming the beneficial owner of 15% or more of our outstanding units, subject to specified exceptions. Each Right entitles the registered holder to purchase from us one one-hundredth of a unit of junior participating preferred units, series I, (Preferred Units) at an exercise price of \$100, subject to adjustment under specified circumstances. If events specified in the Rights Agreement occur, each holder of Rights other than the acquiring person can exercise their Rights.

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When a holder exercises a Right, the holder will be entitled to receive units valued at a multiple of the exercise price of the Right specified in the Rights Agreement. In some cases, the holder will receive cash, property or other securities instead of units. We may redeem the Rights for \$0.001 per Right at any time prior to the tenth day after a person or group becomes an acquiring person.

The Rights will expire on June 30, 2016, unless extended or earlier redeemed or exchanged, and are protected by customary anti-dilution provisions. Preferred Units purchasable upon exercise of the Rights will not be redeemable. Each Preferred Unit will be entitled to share in our distributions of available cash pro rata with the units. In the event of liquidation, the holders of the Preferred Units will be entitled to a minimum preferential liquidation payment of \$100 per unit. Each Preferred Unit will have 100 votes, voting together with the units. Finally, in the event of any merger, consolidation or other transaction in which units are exchanged, each Preferred Unit will be entitled to receive 100 times the amount received per unit.

8. EMPLOYEE BENEFIT PLANS

In connection with our initial public offering and the Transition Agreement, Valero GP, LLC established new benefit plans for employees as follows:

Valero GP, LLC Thrift Plan

Effective June 26, 2006, we established the Valero GP, LLC Thrift Plan (the Thrift Plan), which is a qualified employee profit-sharing plan. Participation in the Thrift Plan is voluntary and is open to substantially all of our employees in the United States who become eligible to participate upon date of hire.

Thrift Plan participants can make basic contributions from 1% up to 8% of their total annual compensation, which includes overtime and cash bonuses. In addition, participants who make a basic contribution of 8% can also make a supplemental contribution of up to 22% of their total annual compensation. The maximum match by us is 75% of each participant's basic contributions up to 8% based on the participant's total annual compensation excluding cash bonuses.

Valero GP, LLC Pension Plan

Effective July 1, 2006, we established the Valero GP, LLC Pension Plan, a qualified non-contributory defined benefit plan (the Pension Plan). The Pension Plan covers substantially all of our employees in the United States and generally provides eligible employees with retirement income based on years of service and compensation during specific periods.

Substantially all of our employees may become eligible to receive benefits after five years of service, including service recognized by Valero Energy for vesting purposes under the Valero Energy pension plan. All benefit obligations associated with employees' service through June 30, 2006, including the effect of future salary increases, are the responsibility of Valero Energy. All benefit obligations related to service on or after July 1, 2006 will be covered by the Pension Plan.

Long-Term Incentive Plans

On July 19, 2006, our board of directors adopted the Valero GP Holdings, LLC Long-Term Incentive Plan (the 2006 LTIP) for our employees, consultants and directors and employees and consultants of our affiliates who perform services for us or our affiliates. The 2006 LTIP allows for the awarding of (i) unit options; (ii) performance units; (iii) restricted units; (iv) phantom units; (v) unit grants; and (vi) unit appreciation rights. The 2006 LTIP permits the granting of awards totaling an aggregate of 2,000,000 units. The 2006 LTIP will be administered by the compensation committee of our board of directors.

Our board of directors, or its compensation committee, in its discretion may terminate, suspend or discontinue the 2006 LTIP at any time with respect to any award that has not yet been granted. Our board of directors, or its compensation committee, also has the right to alter or amend the

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2006 LTIP or any part of the 2006 LTIP from time to time, including increasing the number of units that may be granted subject to unitholder approval as required by the exchange upon which the units are listed at that time. However, no change in any outstanding grant may be made that would materially impair the rights of the participant without the consent of the participant.

On August 22, 2006, we granted 2,886 restricted units of Valero GP Holdings to our directors. One third of the units granted will vest on the anniversary of the grant over three years.

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Excess Thrift Plan, Excess Pension Plan and SERP

Effective July 1, 2006, Valero GP, LLC established an excess thrift plan (the Excess Thrift Plan), an excess pension plan (the Excess Pension Plan) and a supplemental executive retirement plan (the SERP). Effective as of July 1, 2006, eligible Valero GP, LLC employees ceased accruing additional benefits under Valero Energy's excess pension plan (the Prior Excess Pension Plan) and Valero Energy's supplemental executive retirement plan (the Prior SERP), and ceased participating in Valero Energy's excess thrift plan.

The Excess Thrift Plan provides benefits to those employees of Valero GP, LLC whose annual additions under the Thrift Plan are subject to the limitations on such annual additions as provided under §415 of the Internal Revenue Code of 1986, as amended (the Code), and/or who are constrained from making maximum contributions under the Thrift Plan by §401(a)(17) of the Code, which limits the amount of an employee's annual compensation which may be taken into account under that plan. The Excess Thrift Plan is comprised of two separate components, consisting of (1) an excess benefit plan as defined under §3(36) of The Employee Retirement Income Security Act of 1974, as amended (ERISA) and (2) a plan that is unfunded and maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. Each component of the Excess Thrift Plan shall consist of a separate plan for purposes of Title I of ERISA.

The Excess Pension Plan provides benefits to those employees of Valero GP, LLC whose pension benefits under the Pension Plan and the Valero Energy pension plan (where applicable) are subject to limitations under the Code, or who are otherwise indirectly constrained by the Code from realizing the maximum benefit available to them under the terms of the Pension Plan and the Valero Energy pension plan (where applicable). The Excess Pension Plan is an excess benefit plan as defined under §3(36) of ERISA, for those benefits provided in excess of Section 415 of the Code. Benefits provided as a result of other statutory limitations are limited to a select group of management or other highly compensated employees. The Excess Pension Plan will assume the liabilities of the Prior Excess Pension Plan as of July 1, 2006 with respect to Valero GP, LLC employees, and will provide a single, nonqualified defined benefit to those Valero GP, LLC employees for their pre-July 1, 2006 benefit accruals under the Prior Excess Pension Plan and their post-July 1, 2006 benefit accruals under the Excess Pension Plan.

The SERP provides those highly compensated, management personnel of Valero GP, LLC who were accruing benefits under the Prior SERP up until July 1, 2006, and those who may subsequently become eligible, with a supplement to the retirement benefit they may otherwise receive under the Pension Plan and the Valero Energy pension plan (where applicable). Benefits under the SERP are limited to a select group of management or other highly compensated employees. The SERP will assume the liabilities of the Prior SERP as of July 1, 2006 with respect to Valero GP, LLC employees, and will provide a single, nonqualified defined benefit to those Valero GP, LLC employees for their pre-July 1, 2006 benefit accruals under the Prior SERP and their post-July 1, 2006 benefit accruals under the SERP.

None of the Excess Thrift Plan, the Excess Pension Plan or the SERP is intended to constitute either a qualified plan under the provisions of Section 401 of the Code or a funded plan subject to ERISA.

Valero GP, LLC assumed the liabilities accrued under the Prior Excess Pension Plan and the Prior SERP related to its employees, totaling \$0.2 million and \$0.9 million, respectively.

In addition to the liabilities associated with the new benefit plans, Valero GP, LLC also retained the liabilities for the benefit obligations related to the post-retirement medical benefits for those employees that are not retirement eligible (employees over 55 years old with 5 years of service and eligible to receive benefits under the Valero Energy pension plan) on July 19, 2006, and certain long-term disability benefits (LTD) under the Valero Energy flex benefits plan totaling \$6.1 million and \$0.6 million, respectively, as of July 1, 2006. Valero Energy retained the responsibility for the post-retirement medical benefit obligation for employees who are retirement eligible on July 19, 2006, and those who subsequently become retirement eligible and elect to receive a benefit on or before December 31, 2006 under the Valero Energy pension plan. We expect to adopt a post-retirement medical benefits plan to be effective July 1, 2006 from which benefits will become payable to eligible employees beginning January 1, 2007.

Medical and other welfare benefits will continue to be provided to Valero GP, LLC employees under the Valero Energy flex benefits plan through December 31, 2006, at which time a new welfare benefit plan will be established by Valero GP, LLC for the following plan year. Valero GP, LLC will reimburse Valero Energy for the medical and other welfare benefits provided to Valero GP, LLC employees through December 31, 2006. Valero L.P. will continue to reimburse us for the cost of medical and other welfare benefits.

All costs incurred by Valero GP Holdings related to these employee benefit plans, excluding compensation expense related to the long-term incentive plans, were and will continue to be reimbursed by Valero L.P. at cost. Long-term incentive plan compensation expense pertaining to employees of Valero GP, LLC was reimbursed by Valero L.P., while such compensation expense pertaining to corporate officers of Valero Energy was reimbursed by Valero Energy affiliates other than us. Prior to July 19, 2006, any liability of ours related to the various employee benefit plans, other than the bonus plans and the long-term incentive plans, was reflected in notes payable to affiliates in our consolidated balance sheets. The liability for the bonus plans was recorded by Valero L.P., and the obligation under the long-term incentive plans is reflected in accrued liabilities in our consolidated balance sheets. Subsequent to July 19, 2006, our liability for these employee benefits is included in other long-term liabilities on our consolidated balance sheet.

The components of net periodic benefit cost related to our defined benefit plans, which are reimbursed to us by Valero L.P., were as follows for the three months ended September 30, 2006 (in thousands):

	Pension Plans (a)	Other Postretirement Benefit Plans
Three months ended September 30, 2006:		
Components of net periodic benefit cost:		
Service cost	\$ 1,588	\$ 130
Interest cost	22	95
Amortization of net loss	5	
Net periodic benefit cost	\$ 1,615	\$ 225

(a) Includes amounts related to the Pension Plan, Excess Pension Plan and SERP.

There have been no contributions to our defined pension plans or other postretirement benefit plans for the three months ended September 30, 2006.

In addition to the benefit plans discussed above, Valero GP, LLC had previously adopted the following long-term incentive plans:

- Valero GP, LLC adopted the 2000 Long-Term Incentive Plan (the 2000 LTIP) under which Valero GP, LLC may award up to 250,000 common units to certain key employees of Valero Energy's affiliates providing services to us and to directors and officers of Valero GP, LLC. Awards under the LTIP can include unit options, restricted units, performance awards, distribution equivalent rights (DERs) and contractual rights to receive common units.
- In June 2003, Valero GP, LLC adopted the 2003 Employee Unit Incentive Plan (the UIP) under which Valero GP, LLC may award up to 500,000 common units to employees of Valero GP, LLC or its affiliates, excluding officers and directors of Valero GP, LLC and its affiliates. Awards under the UIP can include unit options, restricted units and distribution equivalent rights (DERs).
- Valero GP, LLC adopted the 2002 Unit Option Plan (the UOP) under which Valero GP, LLC may award up to 200,000 unit options to officers and directors of Valero GP, LLC or its affiliates.

Valero L. P. has previously and will continue to reimburse us for the cost of the 2000 LTIP, the UIP and the UOP.

Amended and Restated 2000 Long-Term Incentive Plan

Effective October 1, 2006, the Valero GP, LLC 2000 Long-Term Incentive Plan was amended as follows:

- increase the number of units authorized for issuance under the Plan from 250,000 units (of which 223,147 have been granted to date) to 1,500,000 units;
- permit the cashless-broker exercise of options;
- provide that if an award under the Plan expires, is cancelled, exercised, paid or otherwise terminates without the delivery of units then the units covered by such award, to the extent of such expiration, cancellation, exercise, payment or termination, shall again be units with respect to which awards under the Plan may be granted;
- amend the Plan to meet the requirements of, and facilitate compliance with, Section 409A of the Internal Revenue Code;
- and amend the definition of Change of Control to reflect that as a result of its recently completed initial public offering, Valero GP Holdings, LLC is now the 100% owner of the general partner of Valero L.P.

9. INCOME TAXES

On August 14, 2006, Valero GP, LLC made an entity classification election to be treated as a corporation for federal income tax purposes under Treasury Regulation §301.7701-3(a). Beginning in the third quarter of 2006, our financial statements reflected Valero GP, LLC's treatment as a separate taxable corporate subsidiary of Valero GP Holdings. We accounted for income taxes under the asset and liability method. Under this method, deferred tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Deferred taxes are measured using enacted tax rates expected to apply to taxable income in the year those temporary differences are expected to be recovered or settled.

The realization of deferred tax assets recorded as of September 30, 2006 is dependent upon our ability to generate future taxable income in the United States. We believe that it is more likely than not that the deferred tax assets as of September 30, 2006 will be realized, based upon expected future taxable income and potential tax planning strategies.

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

FORWARD-LOOKING STATEMENTS

This Form 10-Q contains certain estimates, predictions, projections, assumptions and other forward-looking statements that involve various risks and uncertainties. While these forward-looking statements, and any assumptions upon which they are based, are made in good faith and reflect our current judgment regarding the direction of our business, actual results will almost always vary, sometimes materially, from any estimates, predictions, projections, assumptions or other future performance suggested in this report. These forward-looking statements can generally be identified by the words anticipates, believes, expects, plans, intends, estimates, forecasts, budgets, projects, could, should, may and similar expressions. These statements reflect our current views with regard to future events and are subject to various risks, uncertainties and assumptions. Please read our quarterly report on Form 10-Q for the quarter ended June 30, 2006, Part II, Item 1A, Risk Factors, for a discussion of certain of those risks, uncertainties and assumptions.

If one or more of these risks or uncertainties materialize, or if the underlying assumptions prove incorrect, our actual results may vary materially from those described in any forward-looking statement. Other unknown or unpredictable factors could also have material adverse effects on our future results. Readers are cautioned not to place undue reliance on this forward-looking information, which is as of the date of the Form 10-Q. We do not intend to update these statements unless it is required by the securities laws to do so, and we undertake no obligation to publicly release the result of any revisions to any such forward-looking statements that may be made to reflect events or circumstances after the date of this report or to reflect the occurrence of unanticipated events.

Overview

We were formed in June 2000 as UDS Logistics, LLC. We changed our name to Valero GP Holdings, LLC in January 2006. In anticipation of our initial public offering, we transferred our ownership of 614,572 common units and 9,599,322 subordinated units of Valero L.P., a publicly traded Delaware limited partnership (NYSE symbol: VLI) to Riverwalk Holdings, LLC, our wholly owned subsidiary. On May 8, 2006, all of the subordinated units converted into Valero L.P. common units on a one-for-one basis in accordance with the terms of the Valero L.P. partnership agreement.

Our only cash generating assets are our indirect ownership interests in Valero L.P. Our aggregate ownership interests in Valero L.P. consist of the following:

- the 2% general partner interest in Valero L.P., which we hold through our 100% ownership interest in Riverwalk Logistics, L.P.;
- 100% of the incentive distribution rights issued by Valero L.P., which entitle us to receive increasing percentages of the cash distributed by Valero L.P., currently at the maximum percentage of 23%; and
- 10,219,282 common units of Valero L.P. representing a 21.4% limited partner interest in Valero L.P.

We account for our ownership interest in Valero L.P. using the equity method. Therefore, our financial results reflect a portion of Valero L.P.'s net income based on our ownership interest in Valero L.P. We have no separate operating activities apart from those conducted by Valero L.P. and therefore generate no revenues from operations.

Valero L.P. conducts substantially all of its business through its operating partnerships and wholly owned subsidiaries, Valero Logistics Operations, L.P. and Kaneb Pipe Line Operating Partnership, L.P. Through its subsidiaries, Valero L.P. is engaged in the crude oil and refined product transportation, terminalling and storage business in the United States, the Netherland Antilles, Canada, Mexico, the Netherlands and the United Kingdom.

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Valero L.P. is required by its partnership agreement to distribute all of its available cash at the end of each quarter, less reserves established by its general partner in its sole discretion to provide for the proper conduct of Valero L.P.'s business or to provide funds for future distributions. Similarly, we are required by our limited liability company agreement to distribute all of our available cash at the end of each quarter, less reserves established by our board of directors.

Recent Developments

On July 19, 2006, our existing membership interests consisted of 10,000,000 units representing limited liability company interests, and a 4.25-for-1 unit split was effected, resulting in 42,500,000 total units outstanding, all of which were

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owned by subsidiaries of Valero Energy, maintaining their pre-split ownership percentages. Immediately subsequent to the unit split, certain subsidiaries of Valero Energy sold 17,250,000 units in an initial public offering (IPO) for a price to the public of \$22.00 per unit. We did not receive any proceeds from this offering. Subsequent to the IPO, subsidiaries of Valero Energy own 25,250,000 units or approximately 59.4% of our outstanding units.

Valero L.P. has issued common units to the public on three separate occasions, which has diluted our ownership percentage. These three issuances have resulted in increases (or credits) in our proportionate share of Valero L.P.'s capital because, in each case, the issuance price per unit exceeded our carrying amount per unit at the time of issuance. We had not recognized any SAB 51 credits in our consolidated financial statements through March 31, 2006 and were not permitted to do so until our subordinated units converted to Valero L.P. common units. In conjunction with the conversion of the subordinated units held by us to common units on May 8, 2006, we recognized the entire balance of \$158.2 million in SAB 51 credits as an increase in our investment in Valero L.P. and an increase to members' equity.

Results of Operations

Three and Nine Months Ended September 30, 2006 Compared to Three and Nine Months Ended September 30, 2005

	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
	(Thousands of Dollars, Except Unit and Per Unit Data)			
Equity in earnings of Valero L.P.	\$ 11,637	\$ 12,203	\$ 32,141	\$ 29,543
General and administrative expenses	(877)		(903)	(16)
Other income (expense), net	(286)	5	(249)	447
Interest income - affiliated		36	53	73
Interest expense - affiliated	(901)	(4,417)	(10,368)	(13,293)
Interest and debt expense	(6)		(6)	
Income before income tax expense	9,567	7,827	20,668	16,754
Income tax expense (benefit)	(130)	21	273	65
Net income	\$ 9,697	\$ 7,806	\$ 20,395	\$ 16,689
Basic net income per unit	\$ 0.23	\$ 0.18	\$ 0.48	\$ 0.39
Weighted average number of basic units outstanding	42,500,000	42,500,000	42,500,000	42,500,000
Diluted net income per unit	\$ 0.23	\$ 0.18	\$ 0.48	\$ 0.39
Weighted average number of diluted units outstanding	42,500,626	42,500,000	42,500,211	42,500,000

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As discussed above, we account for our investment in Valero L.P. using the equity method. As a result, our equity in earnings of Valero L.P., our only source of income, directly fluctuates with the amount of Valero L.P.'s distributions, which determines the amount of our incentive distribution earnings, and the results of operations of Valero L.P. which determines the amounts of earnings attributable to our general partner and limited partner interests. The following table summarizes Valero L.P.'s results of operations and our equity in earnings of Valero L.P. for the three and nine months ended September 30, 2006 and 2005:

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2006	2005	2006	2005
Valero L.P. Statement of Income Data:				
Revenues	\$ 291,023	\$ 258,385	\$ 844,995	\$ 373,326
Operating income	54,380	56,007	157,663	105,031
Income from continuing operations	41,169	40,861	112,550	78,977
Net income	41,169	45,167	112,173	83,283
Net income per unit applicable to limited partners	0.79	0.88	2.13	2.45
Cash distributions per unit applicable to limited partners	0.915	0.855	2.685	2.510
Valero GP Holdings Equity in Earnings of Valero L.P.:				
General partner interest	\$ 753	\$ 843	2,033	\$ 1,553
General partner incentive distribution	3,909	3,049	10,869	5,662
Direct charges to Valero GP Holdings, LLC	(352)	()	(352)	()
General partner's interest in net income and incentive distributions of Valero L.P.	4,310	3,892	12,550	7,215
Valero GP Holdings' limited partner interest in net income of Valero L.P.	8,048	9,032	21,754	24,491
Amortization of step-up in basis related to Valero L.P.'s assets and liabilities	(721)	(721)	(2,163)	(2,163)
Valero GP Holdings' equity in earnings of Valero L.P.	\$ 11,637	\$ 12,203	\$ 32,141	\$ 29,543

Three Months Ended September 30, 2006 and 2005

Valero L.P.'s income from continuing operations for the three months ended September 30, 2006 increased slightly compared to the three months ended September 30, 2005, despite a decline in consolidated segmental operating income. Lower income tax expense for the three months ended September 30, 2006, compared to the three months ended September 30, 2005, offset the decline in consolidated segmental operating income and higher general and administrative expense. Net income decreased for the three months ended September 30, 2006 compared to the three months ended September 30, 2005 due to the effect of income from discontinued operations in 2005.

Lower earnings at Valero L.P. for the three months ended September 30, 2006 decreased our equity in earnings related to our general partner interest for the three months ended September 30, 2006 compared to that period of 2005.

Valero L.P.'s per unit distributions for the three months ended September 30, 2006 increased to \$0.915 from \$0.855 compared to the same period of 2005, which resulted in Valero L.P. increasing its total cash distributions. Because our

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incentive distribution rights entitle us to an increasing amount of Valero L.P.'s cash distributions, our equity in earnings related to our incentive distribution rights increased.

Our equity in earnings of Valero L.P. related to our limited partner units decreased for the three months ended September 30, 2006 compared to the three months ended September 30, 2005 due to the decline in Valero L.P.'s net income per unit during that period.

General and administrative expenses increased for the three months ended September 30, 2006 compared to the same period in 2005 due to the costs we incurred as a separate publicly traded company, including certain one-time costs associated with our initial public offering. For the period prior to our initial public offering on July 19, 2006, no corporate costs were allocated to us by Valero Energy as management determined that no such corporate costs were incurred specifically on our behalf.

Affiliated interest expense decreased for the three months ended September 30, 2006 compared to the three months ended September 30, 2005 due to Valero Energy's capital contribution to us of the outstanding balance of the Notes effective July 19, 2006, in conjunction with the IPO.

Nine Months Ended September 30, 2006 and 2005

Valero L.P.'s income from continuing operations for the nine months ended September 30, 2006 increased \$33.6 million compared to the nine months ended September 30, 2005 due to higher consolidated segmental operating income and higher equity earnings in joint ventures, partially offset by increased general and administrative expense and increased interest expense. All of these increases predominantly resulted from the Kaneb Acquisition.

Higher earnings at Valero L.P. for the nine months ended September 30, 2006 caused an increase in our equity earnings related to our general partner interest for the nine months ended September 30, 2006 compared to that period of 2005.

Valero L.P.'s per unit distributions for the nine months ended September 30, 2006 increased compared to the same period of 2005 to \$2.685 from \$2.510. That increase coupled with an increase in the number of Valero L.P. units outstanding resulting from the issuance of units in conjunction with the Kaneb Acquisition resulted in Valero L.P. increasing its total cash distributions. Because our incentive distribution rights entitle us to an increasing amount of Valero L.P.'s cash distributions, our equity in earnings of Valero L.P. related to our incentive distribution rights also increased for that period.

Our equity in earnings of Valero L.P. related to our limited partner units decreased for the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 due to the decline in Valero L.P.'s net income per unit during that period.

General and administrative expenses increased for the nine months ended September 30, 2006 compared to the same period in 2005 due to the costs we incurred as a separate publicly traded company, including certain one-time costs associated with our initial public offering. For the period prior to our initial public offering on July 19, 2006, no corporate costs were allocated to us by Valero Energy as management determined that no such corporate costs were incurred specifically on our behalf.

Affiliated interest expense decreased for the nine months ended September 30, 2006 compared to the nine months ended September 30, 2005 due to Valero Energy's capital contribution to us of the outstanding balance of the Notes effective July 19, 2006, in conjunction with the IPO.

Income tax expense (benefit) for the three and nine months ended September 30, 2006 and 2005, relates to federal and state income and withholding taxes currently payable and deferred federal and state income taxes resulting from temporary differences between financial statement and tax bases of assets and liabilities when such differences exist.

Technical Termination under IRC §708(b)(1)(B)

Valero Energy has stated its intention to sell its remaining interests in us, pending market conditions. If Valero Energy completes the sale of its remaining interests such that 50% or more of the total interests in our capital and profits are sold within a twelve-month period, our partnership will terminate for federal income tax purposes. A technical termination is a federal income tax concept that has no impact on the day-to-day business or operations of a partnership. A technical termination of our

partnership for tax purposes will result in a deemed sale or exchange of our interests in Valero L.P.'s capital and profits. This deemed sale or exchange of our interests in Valero L.P.'s capital and profits will also cause the technical termination of Valero L.P.'s partnership for federal income tax purposes if this deemed sale, together with all other sales of Valero L.P.'s units, results in a sale or exchange of 50% or more of its capital and profits interest within a twelve-month period. A technical termination would, among other things, result in the closing of our taxable year for all unitholders and would result in a deferral of depreciation and cost recovery deductions allowable in computing our taxable income. Thus, if this occurs, our unitholders will be allocated an increased amount of federal taxable income for the year in which we are considered to be terminated, and for future years, as a percentage of the cash distributed to unitholders with respect to that period. The technical termination of our partnership and Valero L.P.'s partnership for federal income tax purposes would have no effect on our or Valero L.P.'s financial position or results of operations.

Outlook

For the remainder of 2006, we expect Valero L.P.'s results of the fourth quarter of 2006 to be lower than the third quarter of 2006 due to higher maintenance expenses and lower expected throughputs due to seasonality.

Valero L.P.'s results for the first quarter of 2007 are expected to be lower than the fourth quarter of 2006 due to several planned outages at its customer's refineries and continued lower expected throughputs due to seasonality.

Despite lower expectations for Valero L.P.'s first quarter of 2007, we expect Valero L.P.'s 2007 annual results to be comparable to 2006. However, we expect operating income to increase by \$15 to \$20 million in 2007 compared to the latest estimate of 2006 operating income. This expected improvement in operating income includes the adverse impact on operating income of higher depreciation of approximately \$15 million. Operating income and depreciation expense are expected to increase primarily due to the effects of the following:

- a full year of operations in 2007 of the St. James crude oil terminal as Valero L.P. expects to complete the acquisition in the fourth quarter of 2006;
- a full year of operations in 2007 of the Burgos project which was completed in July 2006; and
- terminal expansion projects at St. Eustatius in the Caribbean and Amsterdam in the Netherlands as well as other internal growth projects that are expected to start contributing to Valero L.P.'s results of operations in 2007.

In addition, we expect higher interest expense to offset the increase in operating income due to higher debt balances, including borrowings related to funding the acquisitions and capital expenditures described above.

Since we expect Valero L.P.'s results for the fourth quarter to be lower than the third quarter of 2006, we expect our equity in earnings of Valero L.P. to be lower. We expect our administrative expenses to be higher compared to historical amounts as we continue to incur additional administrative expenses as a separate publicly traded company.

On July 19, 2006, Valero Energy made a capital contribution to us of the outstanding balance of our notes payable to affiliates, and therefore, we will no longer incur interest expense on the outstanding balance of the notes payable to affiliates. Accordingly, our interest expense in future periods will depend upon the amount of outstanding borrowings and the interest rate related to our three-year revolving credit facility with a borrowing capacity of up to \$20 million. During the three months ended September 30, 2006, we borrowed \$1.0 million under the Credit Facility.

On August 14, 2006, Valero GP, LLC, our wholly owned subsidiary, made an entity classification election to be treated as a corporation for federal income tax purposes under Treasury Regulation §301.7701-3(a). Beginning in the third quarter of 2006, our financial statements reflected Valero GP, LLC's treatment as a separate taxable corporate subsidiary of Valero GP Holdings.

LIQUIDITY AND CAPITAL RESOURCES

General

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Our cash flows consist of distributions from Valero L.P. on our partnership interests, including all of the incentive distribution rights that we own. Due to our ownership of Valero L.P.'s incentive distribution rights, our portion of Valero L.P.'s total distributions may exceed our percentage ownership interest of 23.4%. Our primary cash requirements are for distributions to members, capital contributions to maintain Riverwalk Logistics, L.P.'s 2% general partner interest in Valero L.P. in the event Valero L.P. were to issue additional units, debt service requirements, if any, and general and administrative expenses. In addition, because Valero GP, LLC elected to be treated as a taxable entity, we may be required to pay income taxes, depending upon the taxable income of Valero GP, LLC. These tax payments may exceed the amount of tax expense recorded on the Consolidated Financial Statements. We expect to fund our cash

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requirements primarily with the quarterly cash distributions we receive from Valero L.P. and borrowings on our three-year revolving credit facility, if necessary.

Cash Flows for the Nine Months Ended September 30, 2006 and 2005

Net cash provided by operating activities for the nine months ended September 30, 2006 was \$21.3 million compared to \$15.4 million for the nine months ended September 30, 2005 primarily due to higher net income. Net cash provided by investing activities for the nine months ended September 30, 2006 was \$7.6 million compared to cash used in investing activities of \$24.4 million for the nine months ended September 30, 2005. The variance was primarily due to a contribution of \$29.7 million to Valero L.P. in 2005, including \$29.2 million to maintain our 2% general partner interest in Valero L.P. as a result of the Kaneb Acquisition by Valero L.P. Net cash used in financing activities for the nine months ended September 30, 2006 was \$27.9 million compared to cash provided by financing activities of \$9.0 million for the nine months ended September 30, 2005 primarily due to the contribution from Valero Energy of \$29.2 million in 2005, which was used to maintain the 2% general partner interest in Valero L.P. as a result of the Kaneb Acquisition.

Cash Distributions

Our limited liability company agreement requires that, within 50 days after the end of each quarter beginning with the quarter ending September 30, 2006, we distribute all of our available cash to the holders of record of our units on the applicable record date. Available cash is defined as all cash on hand at the end of any calendar quarter less the amount of cash reserves necessary or appropriate, as determined in good faith by our board of directors, to fund debt we may incur, if any, general and administrative expenses, future distributions and other miscellaneous uses of cash.

The table set forth below shows the cash distributions earned for the periods shown with respect to our ownership interests in Valero L.P. and incentive distribution rights (dollars and units in thousands, except per unit amounts):

	Cash Distributions Made by Valero L.P. (a)			
	Three Months Ended		Nine Months Ended	
	September 30, 2006	2005	September 30, 2006	2005
Cash distributions per unit	\$ 0.915	\$ 0.855	\$ 2.685	\$ 2.510
Average number of Valero L.P. limited partner units outstanding (b)	46,810	46,810	46,810	38,887
Total cash distributions made by Valero L.P. to all partners	\$ 47,694	\$ 43,950	\$ 139,340	\$ 107,845
Cash distributions we received from Valero L.P.:				
Distributions on general partner interest (2%)	\$ 955	\$ 879	\$ 2,787	\$ 2,157
Distributions on incentive distribution rights	3,909	3,049	10,869	7,210
Distributions on our limited partnership interests	9,350	8,740	27,447	25,675
Total cash distributions received by us	\$ 14,214	\$ 12,668	\$ 41,103	\$ 35,042
Distributions to us as a percentage of total cash distributions	29.8	% 28.8	% 29.5	% 32.5

(a) Distributions declared for a quarter are paid by Valero L.P. within 45 days following the end of each quarter based on the partnership interests outstanding as of a record date that is set after the end of each quarter.

(b) Average number of Valero L.P. limited partner units outstanding on the distribution record dates for the periods presented.

Long-Term Contractual Obligations

Credit Facility

On July 19, 2006, we entered into a three-year revolving credit facility with a borrowing capacity of up to \$20 million (the Credit Facility) to enable us to manage our cash flow obligations. For example, we expect to fund capital contributions in Valero L.P. to maintain our 2% general partner interest in the event Valero L.P. issues additional units through borrowings under the Credit Facility, and we may initially meet other liquidity and capital resource requirements through borrowings under the Credit Facility.

Of the Credit Facility's \$20 million commitment, up to \$10 million may be available for letters of credit. Our obligations under the Credit Facility are unsecured. The Credit Facility contains customary covenants and provisions including

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limitations on indebtedness, liens, dispositions of material property, mergers and asset transfers. Borrowings under the Credit Facility bear interest, at our option, at either: (i) the higher of (a) JPMorgan Chase Bank, N.A.'s prime rate or (b) the federal funds effective rate plus one-half percent; or (ii) the Eurodollar rate, as adjusted for statutory reserve requirements for Eurocurrency liabilities, plus an applicable margin that will vary between 0.27% and 0.70% based upon our credit rating.

Under the terms of the Credit Facility, Valero L.P. will be required to maintain a total debt-to-EBITDA ratio of less than 4.75-to-1.0 for any four consecutive quarters, subject to adjustment following certain acquisitions. We are also required to receive cash distributions of at least \$25.0 million in respect to our ownership interests in Valero L.P. for the preceding four fiscal quarters ending on the last day of each fiscal quarter.

Additionally, the Credit Facility contains customary events of default, including in the event of a change in control, that could result in the acceleration of all amounts and cancellation of all commitments outstanding under the Credit Facility. A change in control is defined to mean any of the following events: (i) we cease, indirectly or directly, to own all of the issued and outstanding equity interests of the general partner(s) of Valero L.P., or we no longer have the power, directly or indirectly, to direct or to cause the direction of the management or the policies of Valero L.P.; or (ii) the occurrence of any transaction that results in any person or group, other than Valero Energy or an entity with unsecured senior debt with an investment grade rating, becoming the beneficial owner of more than 50% of our equity interests.

During the three months ended September 30, 2006, we borrowed \$1.0 million under the Credit Facility, which bears interest at 5.9%. As of September 30, 2006, we had \$19.0 million available for borrowing under the Credit Facility.

Administration Agreement

We entered into an Administration Agreement with Valero GP, LLC on July 19, 2006. The Administration Agreement provides, among other things, that:

- Valero GP, LLC provides all employees for us; and
- Valero GP, LLC provides us with all executive management and other administrative services.

The annual charges to be paid under the Administration Agreement will be \$0.5 million. This amount will be increased annually to reflect Valero GP, LLC's annual merit increases. Any other adjustments to the annual fee, such as adjustments to reflect changes in the levels of service provided to us or Valero GP, LLC's actual payroll cost, are subject to the approval of Valero GP, LLC's conflicts committee. We will also reimburse Valero GP, LLC for all direct public company costs and any other direct costs, such as outside legal and accounting fees, that Valero GP, LLC incurs while providing services to us pursuant to the Administration Agreement.

The Administration Agreement will terminate on December 31, 2011, with automatic two-year renewals unless terminated by either party on six months' written notice. We may cancel or reduce the services provided under this agreement on 60 days written notice. The Administration Agreement will terminate upon the change of control of either us or Valero GP, LLC.

Employee Benefits

On October 13, 2006, Valero GP Holdings entered into an Employee Benefits Transition Agreement effective as of July 1, 2006 (the Transition Agreement). Prior to July 1, 2006, the employees of Valero GP, LLC were included in the various employee benefit plans of Valero Energy. These plans include a defined benefit pension plan, a retiree welfare benefit plan, health and welfare benefits, a defined contribution retirement plan, equity incentive plans and nonqualified deferred compensation plans. In accordance with the Transition Agreement and in connection with the initial public offering on July 19, 2006, employees of Valero GP, LLC began participating in newly enacted, comparable plans sponsored by Valero GP, LLC.

In connection with this transition, Valero Energy and certain of its subsidiaries transferred related liabilities and assets totaling \$7.9 million to Valero GP Holdings. In addition, Valero Energy, at its cost and expense, agreed to assist Valero GP, LLC in the design, preparation and initial implementation of Valero GP, LLC's employee benefit plans. Under the transition agreement, Valero Energy will continue to provide the transition services and arrangements described therein through the earlier of the completion of such services and arrangements or the effective date of the final sale by Valero Energy of its remaining membership interest in Valero GP Holdings, unless the parties otherwise agree.

Valero GP, LLC established new benefit plans for employees as follows:

Valero GP, LLC Thrift Plan

Effective June 26, 2006, we established the Valero GP, LLC Thrift Plan (the Thrift Plan), which is a qualified employee profit-sharing plan. Participation in the Thrift Plan is voluntary and is open to substantially all of our employees in the United States who become eligible to participate upon date of hire.

Thrift Plan participants can make basic contributions from 1% up to 8% of their total annual compensation, which includes overtime and cash bonuses. In addition, participants who make a basic contribution of 8% can also make a supplemental contribution of up to 22% of their total annual compensation. The maximum match by us is 75% of each participant's basic contributions up to 8% based on the participant's total annual compensation excluding cash bonuses.

Valero GP, LLC Pension Plan

Effective July 1, 2006, we established the Valero GP, LLC Pension Plan, a qualified non-contributory defined benefit plan (the Pension Plan). The Pension Plan covers substantially all of our employees in the United States and generally provides eligible employees with retirement income based on years of service and compensation during specific periods.

Substantially all of our employees may become eligible to receive benefits after five years of service, including service recognized by Valero Energy for vesting purposes under the Valero Energy pension plan. All benefit obligations associated with employees' service through June 30, 2006, including the effect of future salary increases, are the responsibility of Valero Energy. All benefit obligations related to service on or after July 1, 2006 will be covered by the Pension Plan.

Long-Term Incentive Plans

On July 19, 2006, our board of directors adopted the Valero GP Holdings, LLC Long-Term Incentive Plan (the 2006 LTIP) for our employees, consultants and directors and employees and consultants of our affiliates who perform services for us or our affiliates. The 2006 LTIP allows for the awarding of (i) unit options; (ii) performance units; (iii) restricted units; (iv) phantom units; (v) unit grants; and (vi) unit appreciation rights. The 2006 LTIP permits the granting of awards totaling an aggregate of 2,000,000 units. The 2006 LTIP will be administered by the compensation committee of our board of directors.

Our board of directors, or its compensation committee, in its discretion may terminate, suspend or discontinue the 2006 LTIP at any time with respect to any award that has not yet been granted. Our board of directors, or its compensation committee, also has the right to alter or amend the 2006 LTIP or any part of the 2006 LTIP from time to time, including increasing the number of units that may be granted subject to unitholder approval as required by the exchange upon which the units are listed at that time. However, no change in any outstanding grant may be made that would materially impair the rights of the participant without the consent of the participant.

On August 22, 2006, we granted 2,886 restricted units of Valero GP Holdings to our directors. One third of the units granted will vest on each anniversary of the grant over three years.

Excess Thrift Plan, Excess Pension Plan and SERP

Effective July 1, 2006, Valero GP, LLC established an excess thrift plan (the Excess Thrift Plan), an excess pension plan (the Excess Pension Plan) and a supplemental executive retirement plan (the SERP). Effective as of July 1, 2006, eligible Valero GP, LLC employees ceased accruing additional benefits under Valero Energy's excess pension plan (the Prior Excess Pension Plan) and Valero Energy's supplemental executive retirement plan (the Prior SERP), and ceased participating in Valero Energy's excess thrift plan.

The Excess Thrift Plan provides benefits to those employees of Valero GP, LLC whose annual additions under the Thrift Plan are subject to the limitations on such annual additions as provided under §415 of the Internal Revenue Code of 1986, as amended (the Code), and/or who are constrained from making maximum contributions under the Thrift Plan by §401(a)(17) of the Code, which limits the amount of an employee's annual compensation which may be taken into account under that plan. The Excess Thrift Plan is comprised of two separate components, consisting of (1) an excess benefit plan as defined under §3(36) of The Employee Retirement Income Security Act of 1974, as amended (ERISA) and (2) a plan that is unfunded and maintained primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees. Each component of the Excess Thrift Plan shall consist of a separate plan for purposes of Title I of ERISA.

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The Excess Pension Plan provides benefits to those employees of Valero GP, LLC whose pension benefits under the Pension Plan and the Valero Energy pension plan (where applicable) are subject to limitations under the Code, or who are otherwise indirectly constrained by the Code from realizing the maximum benefit available to them under the terms of the Pension Plan and the Valero Energy pension plan (where applicable). The Excess Pension Plan is an excess benefit plan as defined under §3(36) of ERISA, for those benefits provided in excess of Section 415 of the Code. Benefits provided as a result of other statutory limitations are limited to a select group of management or other highly compensated employees. The Excess Pension Plan will assume the liabilities of the Prior Excess Pension Plan as of July 1, 2006 with respect to Valero GP, LLC employees, and will provide a single, nonqualified defined benefit to those Valero GP, LLC employees for their pre-July 1, 2006 benefit accruals under the Prior Excess Pension Plan and their post-July 1, 2006 benefit accruals under the Excess Pension Plan.

The SERP provides those highly compensated, management personnel of Valero GP, LLC who were accruing benefits under the Prior SERP up until July 1, 2006, and those who may subsequently become eligible, with a supplement to the retirement benefit they may otherwise receive under the Pension Plan and the Valero Energy pension plan (where applicable). Benefits under the SERP are limited to a select group of management or other highly compensated employees. The SERP will assume the liabilities of the Prior SERP as of July 1, 2006 with respect to Valero GP, LLC employees, and will provide a single, nonqualified defined benefit to those Valero GP, LLC employees for their pre-July 1, 2006 benefit accruals under the Prior SERP and their post-July 1, 2006 benefit accruals under the SERP.

None of the Excess Thrift Plan, the Excess Pension Plan or the SERP is intended to constitute either a qualified plan under the provisions of Section 401 of the Code or a funded plan subject to ERISA.

Valero GP, LLC assumed the liabilities accrued under the Prior Excess Pension Plan and the Prior SERP related to its employees, totaling \$0.2 million and \$0.9 million, respectively.

In addition to the liabilities associated with the new benefit plans, Valero GP, LLC also retained the liabilities for the benefit obligations related to the post-retirement medical benefits for those employees that are not retirement eligible (employees over 55 years old with 5 years of service and eligible to receive benefits under the Valero Energy pension plan) on July 19, 2006, and certain long-term disability benefits (LTD) under the Valero Energy flex benefits plan totaling \$6.1 million and \$0.6 million, respectively, as of July 1, 2006. Valero Energy retained the responsibility for the post-retirement medical benefit obligation for employees who are retirement eligible on July 19, 2006, and those who subsequently become retirement eligible and elect to receive a benefit on or before December 31, 2006 under the Valero Energy pension plan. We expect to adopt a post-retirement medical benefits plan that will provide comparable benefits to our employees beginning January 1, 2007.

Medical and other welfare benefits will continue to be provided to Valero GP, LLC employees under the Valero Energy flex benefits plan through December 31, 2006, at which time a new welfare benefit plan will be established by Valero GP, LLC for the following plan year. Valero GP, LLC will reimburse Valero Energy for the medical and other welfare benefits provided to Valero GP, LLC employees through December 31, 2006. Valero L.P. will continue to reimburse us for the cost of medical and other welfare benefits.

All costs incurred by Valero GP Holdings related to these employee benefit plans, excluding compensation expense related to the long-term incentive plans, were and will continue to be reimbursed by Valero L.P. at cost. Long-term incentive plan compensation expense pertaining to employees of Valero GP, LLC was reimbursed by Valero L.P., while such compensation expense pertaining to corporate officers of Valero Energy was reimbursed by Valero Energy affiliates other than us. Prior to July 19, 2006, any liability of ours related to the various employee benefit plans, other than the bonus plans and the long-term incentive plans, was reflected in notes payable to affiliates in our consolidated balance sheets. The liability for the bonus plans was recorded by Valero L.P., and the obligation under the long-term incentive plans is reflected in accrued liabilities in our consolidated balance sheets. Subsequent to July 19, 2006, our liability for these employee benefits is included in other long-term liabilities on our consolidated balance sheet.

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In addition to the benefit plans discussed above, Valero GP, LLC had previously adopted the following long-term incentive plans:

- Valero GP, LLC adopted the 2000 Long-Term Incentive Plan (the 2000 LTIP) under which Valero GP, LLC may award up to 250,000 common units to certain key employees of Valero Energy's affiliates providing services to us and to directors and officers of Valero GP, LLC. Awards under the LTIP can include unit options, restricted units, performance awards, distribution equivalent rights (DERs) and contractual rights to receive common units.
- In June 2003, Valero GP, LLC adopted the 2003 Employee Unit Incentive Plan (the UIP) under which Valero GP, LLC may award up to 500,000 common units to employees of Valero GP, LLC or its affiliates, excluding officers and directors of Valero GP, LLC and its affiliates. Awards under the UIP can include unit options, restricted units and distribution equivalent rights (DERs).
- Valero GP, LLC adopted the 2002 Unit Option Plan (the UOP) under which Valero GP, LLC may award up to 200,000 unit options to officers and directors of Valero GP, LLC or its affiliates.

Valero L. P. has previously and will continue to reimburse us for the cost of the 2000 LTIP, the UIP and the UOP.

Amended and Restated 2000 Long-Term Incentive Plan

Effective October 1, 2006, the Valero GP, LLC 2000 Long-Term Incentive Plan was amended as follows:

- increase the number of units authorized for issuance under the Plan from 250,000 units (of which 223,147 have been granted to date) to 1,500,000 units;
- permit the cashless-broker exercise of options;
- provide that if an award under the Plan expires, is cancelled, exercised, paid or otherwise terminates without the delivery of units then the units covered by such award, to the extent of such expiration, cancellation, exercise, payment or termination, shall again be units with respect to which awards under the Plan may be granted;
- amend the Plan to meet the requirements of, and facilitate compliance with, Section 409A of the Internal Revenue Code;
- and amend the definition of Change of Control to reflect that as a result of its recently completed initial public offering, Valero GP Holdings, LLC is now the 100% owner of the general partner of Valero L.P.

Other Contingencies

As previously discussed, our only cash-generating assets are our indirect ownership interests in Valero L.P. Valero L.P. is subject to certain loss contingencies (see Part II, Item 1. Legal Proceedings), the outcome of which could have an effect on Valero L.P.'s cash flows. Specifically, Valero L.P. may be required to make substantial payments to the U.S. Department of Justice for certain remediation costs.

CRITICAL ACCOUNTING POLICIES

The preparation of financial statements in accordance with United States generally accepted accounting principles requires management to make estimates and assumptions that affect the amounts reported in the consolidated financial statements and accompanying notes. Actual results could differ from those estimates. Our critical accounting policies are disclosed in our registration statement on Form S-1, as amended.

Item 4. Controls and Procedures

(a) Evaluation of disclosure controls and procedures.

Our management has evaluated, with the participation of our principal executive officer and principal financial officer, the effectiveness of our disclosure controls and procedures (as defined in Rule 13a-15(e) under the Securities Exchange Act of 1934) as of the end of the period covered by this report, and has concluded that our disclosure controls and procedures were effective as of September 30, 2006.

(b) Changes in internal control over financial reporting.

There has been no change in our internal control over financial reporting that occurred during our last fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

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PART II - OTHER INFORMATION

Item 1. Legal Proceedings

Valero GP Holdings, LLC is not currently a party to any material legal proceedings. However, our subsidiaries are named as a defendant in litigation relating to their normal business operations, including regulatory and environmental matters. As used in this Part II of this report (unless otherwise specified), we, us and our refer to Valero GP Holdings, LLC and its subsidiaries. We are insured against various business risks to the extent we believe is prudent; however, there can be no assurance that the nature and amount of such insurance will be adequate, in every case, to indemnify us against liabilities arising from future legal proceedings as a result of our ordinary business activity.

The information below describes new proceedings or material developments in proceedings that we previously reported in our annual report on Form 10-K for the year ended December 31, 2005, or our quarterly report on Form 10-Q for the quarter ended June 30, 2006.

Environmental Enforcement Matters

As we first reported in our quarterly report on Form 10-Q for the quarter ended June 30, 2006, the California Bay Area Air Quality Management District proposed penalties totaling \$494,000 for alleged air violations at the Martinez Terminal. The Martinez Terminal was sold to Pacific Energy Group LLC, a subsidiary of Pacific Energy Partners, L.P., on September 30, 2005. As part of the asset purchase agreement, Pacific Energy Group LLC, a subsidiary of Pacific Energy Partners, L.P., assumed responsibility for the notices of violation at the Martinez Terminal. A settlement agreement has been signed by all parties, and Pacific will pay the total amount of penalty assessed.

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

Item 6. Exhibits

- +Exhibit 10.01 Form of Non-employee Director Restricted Unit Agreement under Valero GP Holdings, LLC Long-Term Incentive Plan- incorporated by reference to Exhibit 10.02 to Valero GP Holdings, LLC's Current Report on Form 8-K dated August 22, 2006 and filed August 25, 2006.
- +*Exhibit 10.02 Employee Benefit Transition Agreement, effective as of July 1, 2006, between Valero Energy Corporation, Valero GP Holdings, LLC and Valero GP, LLC.
- *Exhibit 31.01 Rule 13a-14(a) Certifications (under Section 302 of the Sarbanes-Oxley Act of 2002).
- *Exhibit 32.01 Section 1350 Certifications (as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002).

* Filed herewith.

+ Identifies management contracts or compensatory plans or arrangements required to be filed as an exhibit hereto.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned, thereunto duly authorized.

VALERO GP Holdings, LLC

(Registrant)

By: /s/ Curtis V. Anastasio

**Curtis V. Anastasio
President and Chief Executive Officer
November 8, 2006**

By: /s/ Steven A. Blank

**Steven A. Blank
Senior Vice President, Chief Financial Officer and Treasurer
November 8, 2006**

By: /s/ Thomas R. Shoaf

**Thomas R. Shoaf
Vice President and Controller
November 8, 2006**

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