Morgan Stanley

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Stock Rating
Overweight

Industry View
Attractive

Valero

Strong Quarter; Overweight with a $75 Price Target

Valero Posts Positive Surprise: Valero's operating earnings were $2.00/share, which compares to Morgan Stanley estimates of $2.00/share. The results were ahead of consensus projections of $1.94/share. Consensus estimates were $1.67/share at the beginning of the quarter.

R&M Results At Record Levels The first full quarter with Premcor rendered positive results. The 4 new plants made $485 MM in operating income or $0.74/share. Profits were penalized by $0.15/share by hedging losses, which are unlikely in 2006. Below-the-line costs were in-line with previous periods.

New Capital Strategies Ahead ? Share repurchases and dividend growth rising, with different patterns in recent periods. We do not think these trends are coincidental but that the new management team will provide greater balance with capital management.

Consensus Estimates To Rise: While we recently increased our estimates and price target for VLO (see "The Golden Age of Refining: Circa 2006" January 9, 2006), we still believe consensus earnings estimates for 2006 appear too low by 30% if spreads in the forward curve materialize. Positive revisions are likely for Integrated Oil and R&M entities, in our opinion.

Maintain Overweight in R&M: Buy VLO and SUN: Using our mid-cycle forecast of $4.65/share and an 85% relative P/E multiple we attain our $75/share price target. Integrated Oils MRO (O, PT $85) and XOM (O, PT $76) represent our top Integrated Oil names.

Attractive View on Integrated Oils and R&M: Integrated Oil and R&M stocks appear to be at least 15% undervalued based on mid-cycle returns on capital. R&M represents the best value per unit of return in the global energy sector at this time, and the Morgan Stanley Model Energy portfolio remains Overweight R&M.

Key Ratios and Statistics

Reuters: VLO.N Bloomberg: VLO US

Refining & Marketing / United States of America

Price target	**$75.00**
Shr price, close (Jan 31, 2006)	$62.43
Mkt cap, curr (mm)	$54,016
52-Week Range	$61.84-24.05

Fiscal Year (Dec)	2004	2005e	2006e	2007e
ModelWare EPS ($)*	**3.95**	**6.65**	**8.25**	**8.50**
Prior ModelWare EPS ($)	**-**	**-**	**-**	**-**
P/E	**5.7**	**14.7**	**11.9**	**11.5**
Consensus EPS ($)	3.33	6.71	7.61	6.33
Div yld (%)	0.6	0.2	0.2	0.2

* = Please see explanation of Morgan Stanley ModelWare later in the note.
e = Morgan Stanley Research estimates

Investment Case

Summary & Conclusions

Valero's Q4 2005 operating profits of $2.00/share were identical to Morgan Stanley's estimate of $2.00/share. The result surpassed consensus expectations of $1.94/share. For perspective, consensus projections were $1.67/sh. as the fourth quarter of 2005 commenced.

While the result exceeded consensus projections, profits would have been $2.15/sh, absent hedging losses of $0.15/sh. Hedging losses approximated $0.50-0.60/share during 2006. This factor is unlikely to have a material impact on the company's financial performance during 2006, in that the program is significantly smaller. The variance between our estimates and Valero's reported numbers are contained in Exhibit 1.

Strong Operating Performance, High Earnings Quality
In refining, operating results were strong as higher throughput and record October margins, offset higher operating and capital costs. The company benefited from a full quarter with the 4 Premcor plants, which generated $485 MM in earnings ($0.74/share). In general Retail results and below the line costs were in line with expectations.

Results are likely to remain strong in 2006 in that operating and industry conditions are projected to remain strong. While consensus projections envision a 7% decline in profits for Valero during 2006-2007, we expect profits to rise by 30-50% during the period. Spreads in the futures market suggest that consensus earnings estimate must rise in 2006, in our opinion.

Free Cash Flow Significant
From a financial perspective, free cash flow is likely to be significant during 2006, especially during the 2nd half of the year, as capital investment on environmental spending recedes. Our projections indicate that that even after the company reduces debt that is maturing during 2006 ($220 MM), and fulfills the remainder of a $360 MM share repurchase program from 2001; that free cash flow will approximate $2.0 billion.

Exhibit 1
Valero's Q4 Results vs. Projections

	Actual Q4-05	MS Est. Q4-05	Per Share Variance
Refining Op. Income	$2,107	$2,102	$0.01
Retail - U.S. Op. Income	51	44	0.01
Retail - NE Op. Income	12	24	(0.02)
Corporate	(173)	(175)	0.00
EBIT	1,997	1,995	
Other Inc./(Exp)	20	15	0.01
Interest Expense	(75)	(73)	(0.00)
Valero LP	9	15	(0.01)
EBT	1,951	1,952	
Income Taxes	(641)	(644)	0.00
Net Income	$1,310	$1,308	
Preferred Dividends	(1)	(3)	
Net Income to Common	$1,309	$1,305	
Diluted Shares Out. (MM)	654.0	654.0	
Earnings Per Share	$2.00	$2.00	
Consensus		$1.94	

Source: Company data, Morgan Stanley Research

Management suggested that while acquisitions are possible, that greater balance is likely between capital investment, and 1) dividend growth, and 2) reduction of debt and 3) equity, in the future. We suspect that additional share repurchase programs are likely, with surplus free cash flow of the magnitude that we envision, able to reduce shares outstanding by 5% annually during 2006 *and* 2007.

Company Description

Valero is the largest US independent refining and marketing company, and offers significant leverage to the light/heavy differential. The company consists of 18 refineries distributed across the US with nearly 3.0 MMBPD of throughput capacity.

Industry View: Attractive

Attractive

GICS Sector: Energy

Strategist's Recommended Weight: 10.4%
S&P 500 Weight: 9.4%

Positioned For The Golden Age $75 PT

- New capital management strategies appear likely and include dividend growth and share repurchases

- Profits in 2006 to exceed those in 2005, if forward curve is sustained

-Free cash flow to exceed $5/sh. in 2006, if forward curve is sustained

-Maintain Overweight, PT $75/share

If so, then higher valuation will likely materialize in the equity market as risk-adjusted returns rise, and combined with our views that consensus earnings estimates will rise during 2006-2007; then strong performance in the equity market is likely for holders of VLO.

Maintaining Overweight and $75 Price Target

We recently increased our earnings estimates and price target for Valero (see our note "The Golden Age of Refining: Circa 2006" January 9, 2006). We are maintaining our 2006 and 2007 earnings projections of $8.25/share and $8.50/share, respectively. Additionally, our normalized earning projection remains unchanged at this time at $4.65/share. That said, we still believe consensus estimates will rise by 30% if spreads in the forward curve materialize. Such upward revisions would lead to higher valuations not only for Valero, but all in the R&M.

Regarding valuation, utilizing our mid-cycle earnings projections of $4.65/share and an 85% P/E relative multiple, we derive our $75/share price target on VLO. Our target multiple is supported by our relative returns and valuation analysis in that Valero's mid-cycle ROCE (13%) in relation to its cost of capital (7%), is supportive of an EV/CE multiple near 2.3x.

Finally, we maintain our Attractive view on the R&M sector believing that every R&M stock will outperform the S&P 500 during 2006-2007. Morgan Stanley requires rating symmetry though and with VLO and SUN offering higher price appreciation based on mid-cycle projections for returns, those stocks are rated Overweight.

Exhibit 2

Turnarounds Seem Significant but only 5% Supply

Refinery	Unit	Capacity MBD	Duration Days
Aruba	Coker #2	35	40
	Coker #2	33	40
	Crude	110	40
Corpus Christi	Crude	110	21
	Coker	18	28
	Cat Cracker	20	21
	Hydrocracker	13	21
Benicia	Hydrocracker	35	10
Memphis	Refinery	190	30
Krotz Spring	Crude	80	15
	Cat Cracker	34	17
McKee	Hydrocracker	30	26
Texas City	Crude	130	21
Paulsboro	FCC	50	32
Quebec	FCC	63	32
	Crude	165	21
	CCR	30	21
Lost Production for First Half 2006		164	
Total Capacity		3,200	
% of Total		5.1%	

Source. Company Data

Refining Margins, Volumes & Sour Discounts To Remain Strong in 2006

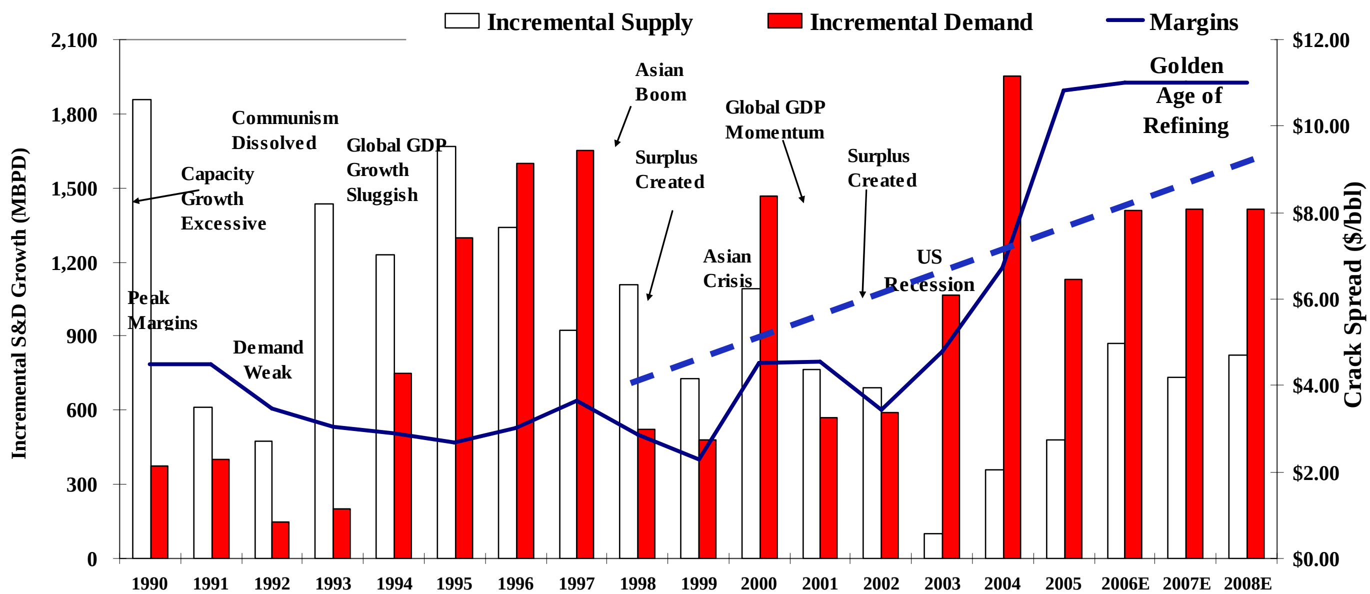
Results in refining were in line with expectations ($2,107 MM vs. $2,102 MM). After considering losses of $160 MM related to hedges on heating oil volumes operating results would have been $2,276 MM.

Record throughput, high October margins and wide sour crude oil discounts all contributed to the positive results. Production averaged 3,025 MBPD in Q4 2005, representing an increase of 770 MBPD over 3Q 2005, as output from the Premcor acquisition was included for a full quarter.

The benchmark 3-2-1 Gulf Coast refining margin approximated $10.10/bbl in the fourth quarter versus $17.13/bbl in Q3 2005 and $4.40/bbl in the year ago period. However, the discount between sour crude oil and light-sweet crude oil was wide with the WTI/Maya spread at $16.00/bbl in Q4 2005, up from $15.26/bbl in Q3 2005.

Exhibit 3

The "Mini-Cycle" of 1996-97, 2000-01 and 2003-06 Are Part of the Same Cycle: "The Golden Age" Is Present



Source. EIA, IEA, Morgan Stanley Research

Spreads between "light-sweet" crude oil and heavier varieties are likely to remain wide in 2006 as discounts on delivery prices for Arab Medium and Arab Heavy continue, and additional residual fuel oil comes into the market as utilization rates increase.

The sour crude oil discount a.k.a. the "light-heavy" differential has become increasingly important to Valero in that it processes 3.0 MMBPD of crude oil; however, nearly 50% of throughput is either heavy/sour or high acid crude oil, the latter of which trade at discounts similar to that of sour crude oils.

If differentials remain wide as envisioned in our "Golden Age of Refining" literature, then positive financial performance should accrue to refiners that process heavier blends of crude oil in relation to those that process lighter varieties. For perspective, for every dollar change in the heavy-sour differential, Valero stands to deliver an *additional* $1.16/share in earnings.

Regarding costs, operating expenses in Refining were $3.55/bbl, and were below Morgan Stanley expectations of $3.67/bbl.

Hedging losses approximated $160 MM in Q4 2005 versus $150 MM in Q3 2005 resulting in an impact of $0.15/share. These losses are set to abate in 2006 in that most contracts expire.

Marketing Performs Ahead of Expectations

In Marketing, results were in line with expectations as profits in US marketing were $51 MM versus expectations of $44 MM. Strong wholesale and merchandise margins more than offset weakness in product sales and higher selling expenses.

The NE retail segment posted operating earnings of $12 MM, which were below our forecast of $24 MM. Volumes were ahead of expectations in the quarter at 3,239 MGPD versus projections of 3,122 MGPD with margins favorable as well. Results were negatively impacted by higher selling expenses during the quarter.

Non-Operating Items In-line with Expectations
Below the operating line, SG&A expenses were $173 MM in line with our expectations of $175 MM. Interest expense rose sequentially to $75 MM up from $67 MM in Q3 2005. We expect this level of interest expense going forward barring significant debt reductions.

Regarding the balance sheet, Valero's net debt to total capitalization was 24.8%, However, after including operating leases in the calculation, we arrive at a debt/capitalization closer to 40%. Discussions with rating agencies continue with increased debt repayment likely to remain the leading use of free cash flow over the near term. Strategic capital programs and share repurchases represent the two other primary uses of free cash flow in coming quarters.

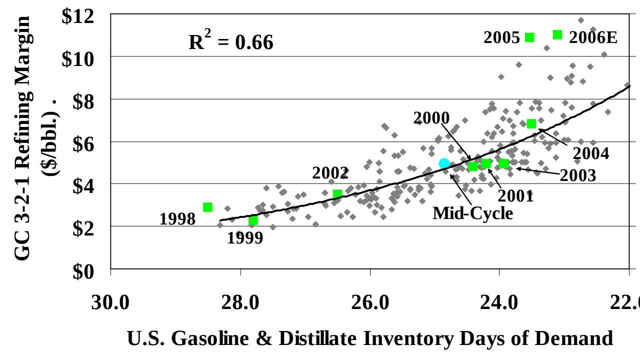
A Major Beneficiary of "The Golden Age of Refining"
Valero stands to be a major beneficiary of our positive "Golden Age of Refining" viewpoint. Additionally, our favorable outlook on markets for refined products is important because, it holds important implications for prices of crude oil and natural gas, in our opinion. It is driven by our view that global growth in demand for "light-products" will exceed that of supply, by at least a 2:1 margin during 2006-2007.

Our estimates for consumption are utilized to form the basis of Morgan Stanley's global outlook for crude oil, which we have called "Higher For Longer", since 2000.

Our assessment of the supply-side is more proprietary, in our opinion, in that it includes analysis of *every* refining project that is planned or under construction worldwide, through 2009. Our analysis also considers the effect on the ability to manufacture "light-products", which we then compare with growth in demand for such, on a global basis.

We are the first to admit that having energy research personnel in important refined product markets around the world enhances the quality of our analysis, such that our projections for demand, capacity, utilization rates and margins may possibly be more accurate. Besides our own analysis in North America, our views draw from analysis in Europe and Latin America by Neil Perry, Irene Himona, and Christian Audi. Important inputs are also received from China/Taiwan (Howard Wong), Russia (Matt Thomas), South Korea (Kenneth Whee), Australia (Stuart Baker), Japan (Lalita Gupta) and India (Vinay Jaising).

Exhibit 4
Outlook for 2006 Very Positive



Source. Morgan Stanley Research

With Morgan Stanley's global research capabilities, and the reality that the time involved to permit, schedule and construct new refining capacity approximates 4 years; all global projects should be included in our projections, through 2008.

Our conclusion is that growth in demand for refined products (3.0 MMBPD) will significantly surpass gains in supply (1.6 MMBPD) during the 2006-2007 period, with the mismatch between gains in demand and supply, similar in each individual year. In our case, utilization rates and margins will likely remain high in global markets for refined products, with additional positive surprises ahead, in our opinion.

Our global fundamental analysis is supported by important signals from global refined products markets, in that with margins at their highest level in 20 years since early 2004; the implication is that global markets for refined products are probably near full utilization at this time, especially for conversion capacity. Our fundamental analysis concludes similarly, with our projections for changes in capacity and demand to manufacture "light-products" contained in Exhibit 3.

In our specific analysis for the US market, we project changes in capacity, demand, and imports of 1.7%, 1.8%, and 0.0% for 2006. In our scenario, inventories are projected to approximate 22.1 days in 2006, which compares to 23.5 days in 2005 and 23.5 days in 2004.

For 2007, we project changes in capacity, demand, and imports of 2.1%, 1.6%, and 5.5%, with inventories projected to approximate 22.1 days next year. Adjustments have been made to reflect expectations for relatively high industry turnarounds during the first half of 2006, and that weather effects, i.e., hurricanes, will not be meaningful in 2006, in relation to 2005. The latter assumption may not prove to be operable if current weather forecasts materialize.

The likelihood that meaningful supply, logistical and distribution issues materialize, which relate to the new environmental regulations that are set for 2006, have rendered lower projections for growth in domestic production, and imports in our model.

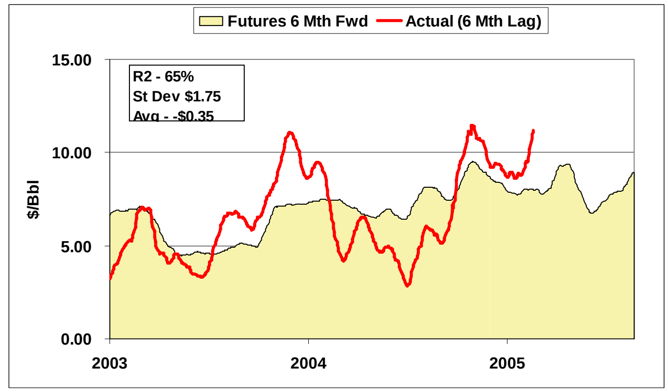
Our weekly projections for capacity, demand and import growth by specific product are available upon request. Our methodology utilizes our fundamental projections to estimate inventories, on an absolute and demand adjusted basis.

We utilize the relationship between inventories and margins in the US refined products market for four reasons. The reasons are as follows: 1) margins are more responsive in the short-term to inventories than to production because inventories are the marginal source of supply, 2) inventories are used to cushion a system that delivers products in batches, 3) companies build or draw down discretionary inventories based on their price expectations and sale opportunities, and 4) inventories rise or decline based on uncertainties or unexpected changes in production and demand. In essence, inventories are an indicator of market pressure on price changes, in our opinion.

In our scenario, we project inventories, which currently approximate 24.8 days, are likely to rise toward 25 days by the end January 2006. At that time though, inventories are projected to begin to decline significantly, as seasonal refinery maintenance is projected to be almost 20% higher than normal during February and March of 2006.

During those 2 months, refinery maintenance is projected to remove approximately 0.9 MMBPD and 0.8 MMBPD of upgrading capacity from the market, which is 20% higher than that during the previous five-year period. Inventories are projected to decline to 22.8 days in March and 22.0 days in April of 2006, with our analysis suggesting that inventories of refined products will be at their lowest levels ever in the US, during the third or fourth week of April 2006.

Exhibit 5
Futures Market Predictive of Forward R&M Margins



Source. Morgan Stanley Research

Margins for refiners of “light-sweet” crude oil are likely to approximate $10.00/bbl in 2006 in our scenario, which compares to spreads of $10.82/bbl in 2005, $6.70/bbl in 2004 and $4.93/bbl in 2003.

For 2006 and 2007, we project margins of $11.00/bbl. Importantly, the forward curve in the futures market is currently at $12/bbl for 2006 and 2007.

While it is unlikely that consensus earnings estimates will rise by 90% and 160% as was the case in 2004 and 2005, respectively; our analysis suggests that additional gains are likely. The consensus of Wall Street analysts projects that earnings in R&M will decline by 8% during 2005-2007, which compares to our projections of a 30% rise during the period. If spreads in the futures market come to fruition, or if companies hedge current margins, then the rise in earnings estimates is likely to be greater.

The spread between WTI and Maya (heavy) crude oils is projected to approximate $13.50/bbl in 2006, which compares to spreads of $15.45/bbl in 2005, $11.32/bbl in 2004 and $6.83/bbl in 2003.

Exhibit 5 relates that the forward curve, defined as the margin one year in advance, has been fairly predictive of margins, as they became posted in the market during the past few years.

Exhibit 6

Fundamental Valuation Methodology

$$\frac{\text{Corporate Return}}{\text{Investor's Required Return}} = \frac{\text{Market Value}}{\text{Capital}}$$

$$\frac{\text{ROCE}}{\text{WACC}} = \frac{\text{Enterprise Value}}{\text{Capital Employed}}$$

Source: Stern Stewart, Morgan Stanley Research

Nearer-term, the fundamental basis for our positive call, remains in US R&M. Inventories, adjusted for demand approximate 24.8 days at present, which compares to the 5-year range of 23.2-26.1 days for this time of year.

While inventories will surely build on a seasonal basis over the next couple of weeks, our fundamental projections suggest that they will begin to decline in February after reaching peaks levels for 2006 in late January. Inventories, adjusted for demand are projected to be near their lowest levels ever during February, March and April of 2006, which suggests that margins are likely to be near record levels as the driving season commences in May.

Of course if supply disruptions related to weather (hurricanes) or geopolitical events (Iraq, Iran, Nigeria, Venezuela etc) materialize, then our projections for margins are likely to prove to be too low. With spreads in the futures markets currently near their highest levels of the past 2 decades, significant market support for our fundamental position is present, in our opinion.

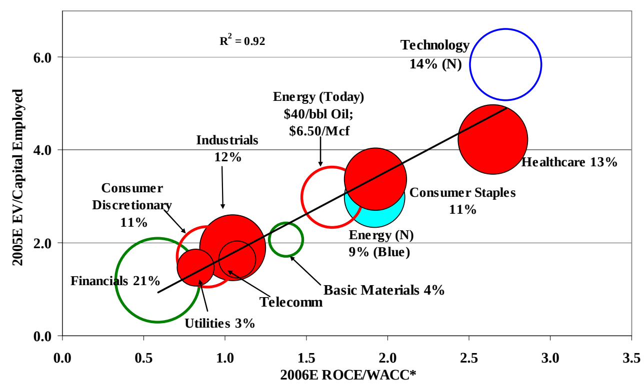
Accordingly, we remain quite positive on the outlook for of 2006 and 2007. This is especially true with the introduction of two major new environmental regulations set for the first half of this year.

Attractive View On Integrated Oils and R&M

Regarding valuation, our methodology assesses returns on capital at mid-cycle levels, which are then compared to valuation in the form of enterprise value/capital employed multiples. A proxy for our approach utilizes normalized or mid-cycle profits, and relative P/E multiples to the overall market.

Exhibit 7

Energy Appears Modestly Undervalued Now



Source: Morgan Stanley Research

This basic returns and valuation relationship is imbedded in our methodology and identifies valuation discrepancies for the S&P sectors and equities in the market. The approach is based on the view that the valuation premium or discount of an entity's capital should equate to its returns on capital in relation to its capital costs — the return an investor could receive from a similarly risky investment.

When entities trade at premiums (discounts) to the values suggested by our projections of their mid-cycle returns in relation to the returns available from a similarly risky investment, such an index or security is overvalued (undervalued), in our opinion.

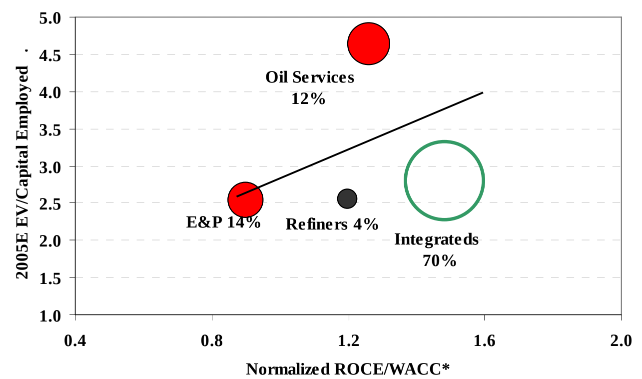
Our investment recommendations on the relevant index or security follow. The basic returns and valuation formula is contained in Exhibit 6.

Fundamental Valuation Methodology

Accordingly, our "top-down" investment position toward the Energy sector and the Integrated Oil and Independent R&M segments emanates from our assessment of consensus projections for risk-adjusted returns (ROCE/WACC) and valuation (EV/CE) for *every* company in the S&P, with results then segmented by sector in the way that portfolio managers group their portfolios.

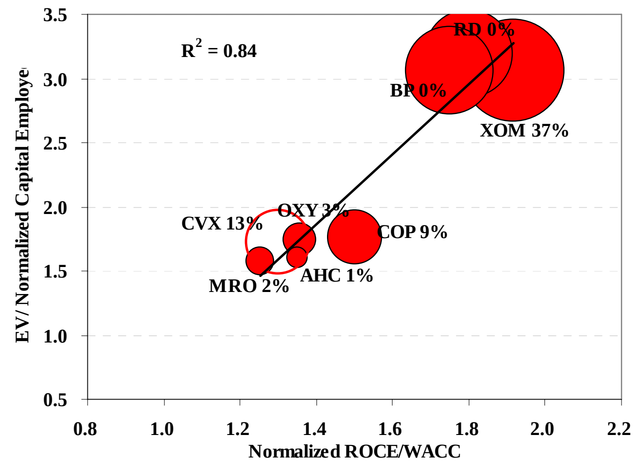
We believe this approach is comprehensive and enables a comparison of returns and valuation relationships between the primary sectors of the S&P 500 and identification of investment opportunities between industries.

Exhibit 8
R&M - Best Value Per Unit of Return in Energy



Source: Morgan Stanley Research

Exhibit 9
MRO, XOM Represent Top Picks



Source: Morgan Stanley Research

The result of our most recent analysis, which was based on closing prices as of this week, is contained in Exhibit 7. Our assessment indicates that the Energy sector is undervalued by 15% based on mid-cycle conditions, which utilizes prices of crude oil and natural gas of $45/bbl (WTI) and $6.50/Mcf, respectively, and the average margin in R&M ($6.20/bbl) and Chemicals over the past cycle.

While questions may arise as to whether mid-cycle or normalized valuation methodologies are most relevant, our experience is that the market rarely discounts commodity prices or margins that are much different than normal in Integrated Oil and R&M equities. For crude oil, the normal or average price during the past five years was $36.25/bbl (WTI), while refining margins have averaged $6.50/bbl (assuming Gulf Coast 3-2-1) over the past 20 quarters.

Our analysis can be extended to the individual sub-industries and companies within Energy as well. Exhibit 7 illustrates that the Energy sector as a whole is undervalued relative to the S&P 500 with refining representing the most attractive segment of the energy group, using our methodology.

Within this context, returns on capital for Independent R&M companies have risen in recent years as capital investment per unit of depreciation has declined and acquisitions have been made at fractions of replacement cost.

Additionally, returns on capital for Independent R&M companies exceed those of Independent E&P companies, a point that surprises many observers. The R&M industry currently trades at the lowest valuation per unit of mid-cycle returns of all of the major segments in the petroleum business (Exhibit 8), we estimate.

For this reason, R&M stocks remain the largest segment bet in Morgan Stanley's global Model Energy Portfolio. Concerns are present and valid — that the current capital spending phase will render lower returns — although we believe that our financial projections appropriately consider this factor.

R&M Attractive: Valuation Positive

We view the R&M segment as Attractive, meaning every stock in the group is expected to outperform in relation to the S&P 500. Besides a favorable fundamental outlook, valuation is positive, and we maintain our favorable viewpoint on the stocks.

Our viewpoint has been that if the "Golden Age of Refining" comes to fruition as expected, then it may not matter which particular equities are owned, and instead that all of the stocks should be purchased (highly correlated).

Accordingly, we maintain our Attractive view on the R&M segment believing that all R&M stocks will outperform the S&P 500 during 2006-2007.

The output from our returns and valuation methodology for the various sectors of the Energy group are contained in Exhibit 8. Our analysis suggests that R&M represents the best value per unit of return in the Energy sector at this time, and therefore it remains the largest sector bet in the global model Energy portfolio.

Regarding the individual stocks, we rate Valero and Sunoco Overweight, Holly and Tesoro Neutral and Frontier and Giant Underweight. To be clear though, our Attractive investment rating on the R&M sector implies that all R&M stocks are likely to outperform the overall market as expectations for industry conditions increase and financial projections rise.

Morgan Stanley requires rating symmetry though, and while we have an equal number of stocks rated Overweight, Equal-Weight and Underweight in the sector, we are positive on all equities in the peer group and expect performance in the stock market to be positive. Additionally, our investment ratings are likely to change as modifications to valuation materialize.

Regarding Valero, utilizing our current mid-cycle forecast for returns on capital of 13%, and a 2.3 EV/CE multiple, we attain our price objective of $75/share. Our target multiple is supported by our relative price/earnings analysis as well, which utilizes our mid-cycle earnings estimate of $4.65/share and a target multiple of 85%. See Exhibit 10 for summary of our EPS estimates.

Sunoco, rated Overweight, utilizes our current mid-cycle forecast for returns on capital of 16.1%, and a 2.7x EV/CE multiple to attain our price objective of $90/share.

Integrated Oil Favorites: MRO, XOM

While our outlook for Amerada Hess is improved, our top ideas in the Integrated Oil area are Marathon Oil (MRO, $73, Overweight, price target $85) and ExxonMobil (XOM, $61, Overweight, $76).

We believe that with the Integrated Oil stocks discounting prices of crude oil near $40/bbl, a decline in prices from $65/bbl to $55/bbl will probably not render significant unfavorable relative performance in the stocks, especially over 6-9 month periods. In our scenario, sector rotation out of Energy may be minimal, especially given higher relative valuations in other sectors at this time.

Exhibit 10

Morgan Stanley's Valero EPS Projections

Annual		
2006E EPS	**2007E EPS**	**Mid Cycle**
$8.25	$8.50	$4.65

Quarter			
Q1-06	**Q2-06**	**Q3-06**	**Q4-06**
$1.11	$2.45	$2.08	$2.60

Source: Company Data, Morgan Stanley Research

While we are rating and price target restricted on ConocoPhillips; we elaborate on our views of the company in our research reports entitled "Major Momentum" and "Major Momentum Revisited."

The story has transitioned from one involving merger-related restructuring, to de-leveraging, to growth and disciplined capital management. The company recently related progress on its return enhancement program, with many of its objectives from the past year met or exceeded.

ExxonMobil remains one of the premier longer-term investment stories in the global petroleum sector, in our opinion. The Exploration and Production segment is set to deliver strong production growth during 2006-2007, and being one of the largest R&M and Chemicals companies, the outlook is positive.

In our view, its financial position is outstanding as well, in that the current cash position approximates $30 billion, and with $40 billion in free cash flow expected in 2006-2007, share repurchases may approximate recent history of $5/billion per quarter.

Using our normalized EPS of $4.00/share and a target multiple of 100% (based on historical range) of the S&P 500, and our 2006 dividend projection of $1.28/share, we attain our 9-12 month price objective of $76/share. (See our basic report "Super Major Supreme" by Doug Terreson, 03-03-04.)

Regarding Marathon, with the company completing the MAP transaction earlier this year, it has become the most levered Integrated Oil in terms of exposure to changes in refining margins. Every $1/bbl change in refining margins affects profits by 11% on a per share basis at normalized conditions.

Using our normalized EPS of $5.75/share and a target multiple of 80% of the S&P 500, we attain our 9-12 month price objective of $85/share. We attain a similar price target by utilizing a 1.9 times enterprise value to capital employed multiple, which is consistent with a mid-cycle ROCE near 13%.

Valuation Methodology and Risks

Regarding the equities, we attain our price objective by applying a relative S&P market multiple to normalized EPS. We utilize the five-year average multiple for valuation with normalized EPS defined as the company's earnings using mid-cycle pricing conditions for its operational segments.

Definitions are listed below:

- Crude Oil: $45/bbl. WTI, $43/bbl. Brent
- US Natural Gas: $6.50/Mcf
- R&M: $6.20/bbl. Gulf Coast 3-2-1 margin
- Chemicals: 2001 - 2005 average earnings

The primary risks for all integrated oil and independent R&M companies remain economic growth, which influences demand for petroleum and prices for crude oil, natural gas, and refined products. Our projections remain consistent with Morgan Stanley's global GDP forecast of 4.2% for 2006 and 3.8% for 2007.

Exhibit 11

Valero Annual Earnings Summary

Income Statement	2003	2004	2005	2006E	2007E	2008E	Normalized
Refining	1,366	3,219	6,465	8,891	9,282	9,282	4,808
Retail-US	118	87	73	85	85	85	67
Retail-NE	95	88	70	66	66	66	93
SG&A	(327)	(421)	(528)	(730)	(700)	(700)	(700)
EBIT	1,250	2,973	6,080	8,312	8,733	8,733	4,267
Other Income	19	14	16	60	60	60	60
Interest Expense	(263)	(260)	(266)	(205)	(200)	(200)	(200)
Valero LP	(7)	29	41	60	60	60	60
Pretax Earnings	999	2,756	5,871	8,227	8,653	8,653	4,187
Minority Interest	(2)	0	0	0	0	0	0
Income Taxes	(366)	(916)	(1,896)	(2,820)	(3,080)	(3,115)	(1,382)
Net Income	633	1,840	3,967	5,407	5,574	5,538	2,806
Preferred Dividend	(3)	(12)	(12)	(12)	(12)	(12)	(12)
Net Income to Common	628	1,827	3,963	5,395	5,562	5,526	2,794
Shares Outstanding Primary (MM)	459.1	510.3	549.7	620.0	620.0	620.0	601.1
Shares Outstanding FD (MM)	489.6	551.7	587.8	654.0	654.0	654.0	601.1
Per Share Amounts	**2003**	**2004**	**2005**	**2006E**	**2007E**	**2008E**	**Normalized**
Earnings	$2.02	$3.33	$6.66	$8.25	$8.50	$8.45	$4.65
Cash Flow	$2.47	$4.75	$8.76	$10.50	$10.90	$10.94	$5.40
Dividend	$0.10	$0.12	$0.19	$0.21	$0.23	$0.25	
Free Cash Flow	-$0.03	$1.43	$3.59	$4.55	$5.49	$6.47	

Source. Company Data, Morgan Stanley Research Estimates

Exhibit 12

Valero Annual Cash Flow Summary

Statement of Cash Flow							
Cash from Operations	**2003**	**2004**	**2005**	**2006E**	**2007E**	**2008E**	**Normalized**
Net Income	622	1,804	3,967	5,407	5,574	5,538	2,794
DD&A	511	618	850	1,100	1,182	1,247	1,182
Working Capital	429	203	0	0	0	0	0
Deferred Tax Benefit (Expense)	193	268	0	0	0	0	0
Other	(1)	64	(29)	(29)	(29)	(28)	0
Total	1,753	2,957	4,788	6,478	6,727	6,757	3,976
Cash from Investing							
Capital Expenditures (Excl. Turns)	(976)	(1,292)	(2,100)	(2,705)	(2,325)	(1,700)	(2,325)
Deferred Turns., Catalyst	(136)	(304)	(500)	(695)	(700)	(700)	(700)
Acquisitions	(401)	(1,198)	0	0	0	0	0
Asset Sales	564	109	100	250	250	250	0
Other	(381)	0	0	0	0	0	0
Total	(1,331)	(2,685)	(2,500)	(3,150)	(2,775)	(2,150)	(3,025)
Cash from Financing							
Net Debt	(372)	63	(2,409)	(760)	(500)	(500)	0
Preferred Dividends	(3)	(5)	(12)	(12)	(12)	(12)	(12)
Common Dividends	(48)	(74)	(104)	(130)	(143)	(157)	(143)
Net Issuance of Preferred Stock	0	0	0	0	0	0	0
Conv. Preferred Stock	0	0	0	0	0	0	0
Other	(286)	0	0	0	0	0	0
Share Transactions	277	223	(570)	(600)	(600)	(600)	0
Total	(431.2)	207	(3,095)	(1,501)	(1,255)	(1,269)	(155)

Cash Flow Summary	**2003**	**2004**	**2005**	**2006E**	**2007E**	**2008E**	**Normalized**
Operations	1,753	2,957	4,788	6,478	6,727	6,757	3,976
Investing	(1,331)	(2,685)	(2,500)	(3,150)	(2,775)	(2,150)	(3,025)
Financing	(431)	207	(3,095)	(1,501)	(1,255)	(1,269)	(155)
Change to Cash	(9)	479	(807)	1,827	2,697	3,338	796

Source. Company Data, Morgan Stanley Research

Exhibit 13

Valero Quarterly Earnings Summary

	2004				2005				2006E			
Quarterly Income Statement	**1Q**	**2Q**	**3Q**	**4Q**	**1Q**	**2Q**	**3Q**	**4Q**	**1Q**	**2Q**	**3Q**	**4Q**
Refining	489	1,086	760	884	932	1,364	2,063	2,106	1,330	2,592	2,236	2,733
Retail-US	3	31	21	31	(15)	31	5	51	5	32	16	33
Retail-NE	32	20	15	21	25	16	16	13	21	17	14	13
SG&A	(92)	(103)	(98)	(128)	(97)	(106)	(152)	(173)	(190)	(185)	(180)	(175)
EBIT	431	1,033	699	809	846	1,306	1,932	1,997	1,166	2,455	2,086	2,604
Other Income	10	(3)	7	0	(2)	(13)	11	20	15	15	15	15
Interest Expense	(62)	(70)	(64)	(64)	(63)	(61)	(67)	(75)	(55)	(50)	(50)	(50)
Valero LP	0	10	10	10	9	10	13	9	15	15	15	15
Pre- Tax Profits	379	970	653	754	790	1,242	1,889	1,951	1,141	2,435	2,066	2,584
Minority Interest	0	0	0	0	0	0	0	0	0	0	0	0
Income Taxes	(137)	(335)	(218)	(226)	(256)	(394)	(605)	(641)	(411)	(828)	(703)	(879)
Net Income	242	635	434	528	534	848	1,284	1,310	730	1,607	1,364	1,705
Preferred Dividend	(3)	(3)	(3)	(3)	(3)	(4)	(4)	(1)	(3)	(3)	(3)	(3)
Net Income to Common	239	632	431	525	531	844	1,280	1,309	727	1,604	1,361	1,702
Shares Outstanding Primary (MM)	503.2	513.6	511.4	513.0	512.8	514.0	552.0	620.0	620.0	620.0	620.0	620.0
Shares Outstanding Fully Dilluted (MM)	544.4	554.4	552.6	555.4	555.2	554.0	588.0	654.0	654.0	654.0	654.0	654.0
Earnings Per Share (Primary)	$0.48	$1.24	$0.85	$1.03	$1.04	$1.65	$2.33	$2.11	$1.18	$2.59	$2.20	$2.75
Earnings Per Share (Fully Diluted)	$0.46	$1.14	$0.79	$0.94	$0.96	$1.52	$2.18	$2.00	$1.11	$2.45	$2.08	$2.60

Source: Company Data, Morgan Stanley Research

Exhibit 14

Independent Refining Valuation Summary

	TKR	Rating	Price at 01/30/06	Target Price	Avg. Debt/ Capital	Avg. Net Debt Capital	Equity Value	Enterprise Value*	Earnings Per Share '04	'05E	'06E	'07E	Normal
Frontier	FTO	U	$46.99	NA	31.5%	-2.6%	$2,657	$2,520	$1.13	$4.00	$4.65	$4.65	$2.55
Giant	GI	U	$69.58	NA	50.2%	42.2%	$1,007	$1,182	$2.39	$7.10	$7.75	$8.00	$4.00
Holly	HOC	E	$73.35	NA	5.1%	-13.8%	$2,186	$1,945	$2.60	$5.40	$6.25	$6.40	$3.55
Sunoco	SUN	O	$96.21	$95	42.9%	28.8%	$13,097	$13,782	$4.31	$7.30	$8.50	$8.50	$6.25
Tesoro	TSO	E	$72.38	NA	42.1%	36.3%	$4,994	$5,472	$4.97	$8.30	$9.15	$9.25	$4.50
Valero	VLO	O	$63.20	$75	28.4%	33.3%	$39,100	$44,651	$6.64	$6.66	$8.25	$8.50	$4.65

	Price to Earnings Ratio '04	'05E	'06E	'07E	Normal	Relative Price / Earnings '04	'05E	'06E	'07E	Normal	EV/EBITDA '04	'05E	'06E	'07E
Frontier	41.6x	11.7x	10.1x	10.1x	18.4x	189.5%	64.4%	58.6%	58.6%	106.8%	15.4x	5.7x	5.2x	5.3x
Giant	29.1x	9.8x	9.0x	8.7x	17.4x	132.8%	53.7%	52.0%	50.4%	100.8%	10.2x	5.1x	4.8x	4.6x
Holly	28.2x	13.6x	11.7x	11.5x	20.7x	128.3%	74.5%	68.0%	66.4%	119.8%	10.4x	6.1x	5.9x	5.9x
Sunoco	22.3x	13.2x	11.3x	11.3x	15.4x	101.7%	72.3%	65.6%	65.6%	89.2%	8.9x	6.8x	6.0x	6.0x
Tesoro	14.6x	8.7x	7.9x	7.8x	16.1x	66.4%	47.8%	45.9%	45.4%	93.2%	7.8x	5.2x	4.7x	4.7x
Valero	9.5x	9.5x	7.7x	7.4x	13.6x	43.4%	52.0%	44.4%	43.1%	78.8%	12.4x	6.4x	4.7x	4.5x
Average	**15.5x**	**10.5x**	**9.0x**	**8.9x**	**15.0x**	**70%**	**57%**	**52%**	**51%**	**87%**				

	TKR	Price at 01/30/06	Crude Volume	Weighted Complexity	Dollar Per Barrel	Dollar Per Complexity Barrel	Cash Flow/Share '04	'05E	'06E	'07E	Normal
Frontier	FTO	$46.99	156	11.1	$16,154	$1,455	$1.87	$4.76	$5.38	$5.41	$3.45
Giant	GI	$69.58	105	8.8	$11,315	$1,286	$4.70	$10.23	$11.02	$11.47	$9.70
Holly	HOC	$73.35	109	9.7	$17,844	$1,840	$3.85	$6.75	$8.03	$8.63	$6.04
Sunoco	SUN	$96.21	935	8.5	$14,740	$1,734	$7.59	$10.39	$13.22	$13.32	$3.89
Tesoro	TSO	$72.38	560	8.1	$9,772	$1,206	$7.37	$10.87	$11.72	$11.79	$6.75
Valero	VLO	$63.20	3,248	12.1	$13,747	$1,136	$4.75	$8.76	$10.50	$10.90	$5.40

	Price to Cash Flow Ratio '04	'05E	'06E	'07E	Normal	ROCE '04	'05E	'06E	'07E	Normal	Price / Book Ratio '04	'05E	'06E	'07E
Frontier	25.1x	9.9x	8.7x	8.7x	13.6x	20.2%	37.9%	35.7%	27.8%	17.0%	10.6x	5.8x	4.4x	3.2x
Giant	14.8x	6.8x	6.3x	6.1x	7.2x	9.1%	16.4%	15.5%	14.0%	6.7%	3.6x	2.4x	1.9x	1.6x
Holly	19.1x	10.9x	9.1x	8.5x	12.1x	15.7%	26.9%	26.5%	23.1%	15.7%	7.0x	5.1x	4.2x	3.5x
Sunoco	12.7x	9.3x	7.3x	7.2x	24.8x	19.5%	23.7%	22.2%	18.5%	17.7%	9.0x	5.4x	3.8x	2.9x
Tesoro	9.8x	6.7x	6.2x	6.1x	10.7x	16.8%	21.2%	18.9%	16.3%	8.9%	3.7x	2.6x	2.0x	1.6x
Valero	13.3x	7.2x	6.0x	5.8x	11.7x	17.6%	19.9%	22.3%	19.6%	10.0%	4.5x	2.4x	2.1x	1.7x
						18.0%	**21.6%**	**21.1%**	**18.1%**	**12.2%**	**5.7x**	**3.5x**	**2.6x**	**2.1x**

		Price at 01/30/06	Current Yield	'04	'05E	'06E	'04	'05E	'06E
S&P 500	SPX	$1,285	1.7%	$58.55	$70.48	$74.50	22.0x	18.2x	17.3x

* Enterprise value is defined as Share Price * Shares Outstanding + Net Debt + Minority Interest + Preferreds
E=Morgan Stanley Research Estimate

Source: Company Data, Morgan Stanley Research Estimates

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(as of January 31, 2006)

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Total	2,098		710		

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Industry Coverage: Refining & Marketing

Company (Ticker)	Rating (as of)	Price (01/31/2006)
Douglas T. Terreson		
Frontier Oil (FTO.N)	U (09/09/2005)	$47.39
Giant Industries (GI.N)	U (09/09/2005)	$69.89
Holly Corporation (HOC.N)	E (09/09/2005)	$73.60
Sunoco Inc. (SUN.N)	O (08/24/2005)	$95.20
Tesoro Petroleum (TSO.N)	E (09/09/2005)	$72.47
Valero (VLO.N)	Overweight (09/09/2005)	$62.43

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