TRANSCRIPT
1Q 2021 EARNINGS CONFERENCE CALL

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MEETING PARTICIPANTS

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Doug Leggate, *BofA Global Research*

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TRANSCRIPT

Operator:

Welcome to the First Quarter 2021 Phillips 66 Earnings Conference Call. My name is Hillary, and I will be your operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded.

I will now turn the call over to Jeff Dietert, Vice President, Investor Relations. Jeff, you may begin.

Jeff Dietert:

Good morning, and welcome to Phillips 66 First Quarter Earnings Conference Call. Participants on today's call will include Greg Garland, Chairman and CEO; Mark Lashier, President and COO; Kevin Mitchell, EVP, Finance, and CFO; Bob Herman, EVP, Refining; Brian Mandell, EVP, Marketing and Commercial; and Tim Roberts, EVP, Midstream.

Today's presentation material can be found on the Investor Relations section of the Phillips 66 website, along with supplemental financial and operating information. Slide 2 contains our safe harbor statement. We will be making forward-looking statements during today's presentation and our Q&A session. Actual results may differ materially from today's comments. Factors that could cause actual results to differ are included here as well as in our SEC filings.

With that, I'll turn over the call to Greg.

Greg C. Garland:

Thanks, Jeff, and good morning, everyone, and thank you for joining us today. First, I'd like to welcome Mark Lashier, our new President and Chief Operating Officer. I think many of you know Mark from his previous role as President and CEO of CPChem. And Mark, it's great to have you here with us at Phillips 66.

In the first quarter, we had an adjusted loss of $509 million or $1.16 per share. Our results reflect the impact of the severe winter storms in the U.S. Gulf Coast and Central regions where we experienced reduced volumes, increased utility costs, and maintenance and repair costs. We safely resumed operations across our businesses following the storm-related downtime. We're proud of our employees and their commitment to operating excellence, particularly during these challenging times.

Gasoline diesel demand continues to recover, and product inventories have normalized, supporting higher refining margins and utilization rates. We expect continued recovery as we wrap up spring turnarounds and head into the summer driving season. Also, chemical facilities are back to normal operations with continued strong demand and margins. We remain optimistic about the impact COVID-19 vaccines and monetary stimulus will have on economic recovery in the back half of the year. Leading indicators suggest economic growth is accelerating, which supports the demand for our products.

In the first quarter, we returned $394 million to shareholders and dividends. We remain committed to a secure, competitive and growing dividend. In February, we repaid $500 million of maturing debt. We will continue with a disciplined approach to capital allocation, including debt repayment as cash generation improves. We'll maintain a conservative balance sheet and a strong investment-grade credit rating.

The South Texas Gateway Terminal commissioned additional storage, bringing the total capacity to 8.6 million barrels. This completes the final construction phase for this project. In addition, the terminal has up to 800,000 barrels per day of export capacity. Phillips 66 Partners owns a 25% interest in the terminal. Phillips 66 Partners continued construction of the C2G Pipeline, connecting its Clemens Storage Caverns to petrochemical facilities in the Corpus Christi area. The project is backed by long-term commitments and is expected to be completed in
mid-2021.

At the Sweeny Hub, we plan to resume construction of Frac 4 in the second half of 2021, which will add 150,000 barrels per day. Upon completion, the Sweeny Hub will have 550,000 barrels per day of fractionation capacity supported by long-term customer commitments. In Chemicals, Chevron Phillips Chemical Company LLC (CPChem) is advancing optimization and de-bottlenecking opportunities. This includes approved projects at its Cedar Bayou facility that will increase the production of ethylene and polyethylene. In addition, CPChem is developing an expansion of its normal alpha olefins' capacity.

We're advancing our Rodeo Renewed project at the San Francisco Refinery. Earlier this month, we began renewable diesel production from the hydrotreater conversion, which will ramp up to 8,000 barrels per day in the third quarter. Subject to permitting and approvals, full conversion of the facility is expected in early 2024. On completion, the facility will have over 50,000 barrels per day of renewable fuel production capacity. This capital-efficient investment is expected to deliver strong returns and reduce the facility's greenhouse gas emissions by 50%. This project will help California meet its lower-carbon objectives.

We're increasing our focus on lower-carbon initiatives across the company. This includes the creation of the Emerging Energy group earlier this year and ongoing research and development by our Energy Research and Innovation organization. We've invested in Shell Rock Soy Processing, a joint venture that plans to construct a new soybean facility in Iowa. We expect the project to be completed in late 2022. We will purchase 100% of the soybean oil production. We signed an MoU with Southwest Airlines to commercialize sustainable aviation fuel. We launched a technical collaboration with Faradion, a leader in sodium-ion battery technology to develop lower- cost, higher-performing anode materials for sodium-ion batteries. These activities further our commitment to addressing the global climate challenge while delivering attractive shareholder returns.

Finally, we'd like to comment on our company's operating excellence. We are honored that our Refining, Midstream and Chemicals businesses were recently recognized for 2020 safety performance. Six of our refineries were recognized by AFPM, including Lake Charles, Ponca City and Santa Maria refineries, which received Distinguished Safety Awards. This is the highest annual safety award in our industry and the fifth year in a row that our refineries have received this honor. Our Midstream businesses were awarded API Distinguished Pipeline Safety Award for Large Operators. This is the highest recognition by API for the midstream industry. In addition, we're recognized by the Gas Processors Association for outstanding safety performance in Midstream. In Chemicals, AFPM selected CPChem's Conroe, Orange and Port Arthur facilities as recipients of the Elite Silver Safety Award.

So, congratulations to all these facilities, well done. We're really proud of you. So, with that, I'm going to turn the call over to Kevin to review the financial results.

Kevin Mitchell:

Thank you, Greg. Hello, everyone. Starting with an overview on slide 4, we summarize our first-quarter results. We reported a loss of $654 million. Special items this quarter included an impairment resulting from Phillips 66 Partners' decision to exit the Liberty Pipeline project as well as winter storm-related maintenance

and repair costs. Excluding these special items, we had an adjusted loss of $509 million or $1.16 per share. We generated operating cash flow of $271 million, including distributions from equity affiliates of $502 million. Capital spending for the quarter was $331 million, including $174 million for growth projects. We paid $394 million in dividends.

Moving to slide 5. This slide shows the change in adjusted results from the fourth quarter to the first quarter, a decrease of $2 million. Improved results in Refining and Marketing and Specialties were offset by lower pre-tax income in the other segments. Our adjusted effective income tax rate was 16%. The rate is influenced by the proportional mix of pre-tax income from domestic, foreign and MLP sources.

Slide 6 shows our Midstream results. First-quarter adjusted pre-tax income was $276 million, a decrease of $47 million from the previous quarter. Transportation contributed adjusted pre-tax income of $206 million, up $10 million from the previous quarter. The increase was due to lower operating costs and higher equity earnings, partially offset by lower volumes. NGL and Other adjusted pre-tax income was $36 million. The $50 million decrease from the prior quarter was mainly due to higher operating costs associated with the winter storms. The Sweeny fractionation complex averaged 330,000 barrels per day, and the Freeport LPG Export facility loaded a record 41 cargoes in the first quarter. DCP Midstream adjusted pre-tax income of $34 million was down $7 million from the previous quarter, mainly due to the winter storms.

Turning to Chemicals on slide 7. First-quarter adjusted pre-tax income was $184 million, down $19 million from the fourth quarter. Olefins and Polyolefins (O&P) adjusted pre-tax income was $174 million. The $42 million decrease from the previous quarter was primarily due to winter storm impacts, which resulted in lower production and higher utility costs. This was partially offset by higher margins primarily due to tight supplies, lower inventory levels and continued strong demand. Global O&P utilization was 79% for the quarter. All impacted CPChem facilities safely restarted operations by early April. Adjusted pre-tax income for SA&S increased $14 million, primarily due to improved margins. During the first quarter, we received $205 million in cash distributions from CPChem.

Turning to Refining on slide 8. Refining first-quarter adjusted pre-tax loss was $1 billion, an improvement of $68 million from the fourth quarter. First-quarter results reflect the impacts of the winter storms. The improvement was driven by higher realized margins, largely offset by increased turnaround costs as well as higher utilities resulting from the winter storms. The increase in realized margins reflects improved crack spreads and the sale of excess electricity to help meet demand in the Texas market, partially offset by lower product differentials and higher RIN costs. Pre-tax turnaround costs were $192 million, up from $76 million in the prior quarter. We completed the majority of our spring turnaround activity this month. Crude utilization was 74% compared with 69% last quarter. The first-quarter clean product yield was 82%.

Slide 9 covers market capture. The 3:2:1 market crack for the first quarter was $13.23 per barrel compared to $7.84 per barrel in the fourth quarter. Realized margin was $4.36 per barrel and resulted in an overall market capture of 33%. Market capture in the previous quarter was 28%. Market capture is impacted by the configuration of our refineries. We make less gasoline and more distillate than premised in the 3:2:1 market crack. During the quarter, the gasoline crack improved $6.38 per barrel while the distillate crack increased $3.41 per barrel.

In addition, we had a lower clean product yield this quarter as a result of turnaround activity and unplanned downtime, which also contributed to the configuration impact. Losses from secondary products of $1.29 per barrel were $0.09 higher than the previous quarter. Feedstock costs improved $0.37 per barrel compared with the prior quarter. The Other category reduced realized margins by $4.78 per barrel. This category

includes RINs, freight costs, clean product realizations and inventory impacts. It also reflects revenues from the sale of excess electricity into the growth.

Moving to Marketing and Specialties on slide 10. Adjusted first-quarter pre-tax income was $290 million compared with $221 million in the prior quarter. Marketing and Other increased $30 million due to higher domestic margins, partially offset by lower international margins. Specialties improved $39 million, largely due to improved base oil and finished lubricant margins. Refined product exports in the first quarter were 204,000 barrels per day.

On slide 11, the Corporate and Other segment had adjusted pre-tax costs of $251 million, an increase of $16 million from the prior quarter. This was primarily due to the timing of charitable contributions and environmental expenses as well as lower capitalized interest.

Slide 12 shows the change in cash for the quarter. We started the year with a $2.5 billion cash balance. Cash from operations was $271 million. This included a working capital benefit of $98 million. In February, we repaid $500 million of floating rate senior notes upon maturity. Capital spending was $331 million, and we paid $394 million in dividends. The Other category includes a $155 million loan to our WRB joint venture. Our ending cash balance was $1.4 billion. At March 31, we had $6.7 billion of committed liquidity, reflecting $1.4 billion of consolidated cash plus available capacity on our credit facilities, $5 billion at Phillips 66 and $299 million at Phillips 66 Partners.

This concludes my review of the financial and operating results. Next, I'll cover a few outlook items.

In Chemicals, we expect the second-quarter global O&P utilization rate to be in the mid-90s. In Refining, crude utilization will be adjusted according to market conditions. In April, utilization has been in the mid-80% range. We expect second-quarter pre-tax turnaround expenses to be between $110 million and $140 million. We anticipate second-quarter Corporate and Other costs to come in between $240 million and $250 million pre-tax.

Now, we will open the line for questions.

Operator:

Thank you. We will now begin the question-and-answer session. Your first question comes from Neil Mehta with Goldman Sachs.

Neil Mehta:

Thank you, and congratulations, Mark, on your new role.

Mark Lashier:

Thanks, Neil.

Neil Mehta:

Maybe I'll start with you, Mark. You and Greg have both spent a lot of time looking at Chemicals over the years. We're obviously in a very strong margin environment right now. Where do you think we are in the polyethylene cycle from a margin perspective? And how are you thinking about the puts and takes? And then it sounds like utilization is ramping pretty well here in the second quarter. Should you be able to run and capture that strong margin, all else equal?

Mark Lashier:

Right, Neil, thanks for the question. If you look at even back into 2020, CPChem experienced really strong demand and outstanding operational excellence margins were suppressed a bit by crude oil pricing, frankly, but we saw the record demand, record production coming out of CPChem. And margins were starting to improve in late 2020, a lot of people have moved turnarounds out into 2021. We needed to build some inventory for those turnarounds and then Winter Storm Uri hit Texas and decimated the inventory in the system.

So, we do see strong fundamentals, and we do see those margins improving even though we didn't realize it in the first quarter because of the winter storm. And so, we believe that CPChem will see the benefit of those margins. So, on average, for the rest of the year, we'll continue to see an increase into the second and third quarter, then maybe some seasonal weakness in the fourth quarter. But on average, we should see CPChem at or above midcycle margins this year.

Neil Mehta:

And has your view of those midcycle margins changed? And maybe that's a question for Greg. I think historically, you said at $0.25 through the cycle fully integrated polyethylene margin.

Greg Garland:

I think if you look at 2012 through 2019 that's about what an average, Neil. And, I think we're pretty comfortable on a go-forward basis. That's going to reference a midcycle number. We look at reinvestment level economics, and what does that take to get you kind of a 12% return, and that's what it is.

Neil Mehta:

Great. And, then the follow-up is just on leverage levels. Going into the pandemic, pre-pandemic, debt levels were around $12 billion consolidated. Today, they're at $15 billion. Just can you take us into some of the conversations you're having with your bondholders and credit agencies around the appropriate leverage level in your mind until you get that leverage down to those levels. Are you constrained about what you can do around the share repurchase program?

Kevin Mitchell:

Hi, Neil, it's Kevin. Let me make a few comments on that. So, you're right, we came into the pandemic with $12 billion of debt. And we added $4 billion over the course of last year. We paid off $0.5 billion in the first quarter. Our primary focus from a leverage standpoint is around the credit rating. So, we have an A3 and BBB+ rating, so very strong investment grade, but we do have a negative outlook on both. And so, we want to get back to maintaining those ratings and with a stable outlook. And to do that, we need to demonstrate that we're getting debt levels back somewhere toward where they were before the pandemic kicked in.

As you think about recovery and cash generation and the things we've done in terms of scaling back our capital and suspension of share repurchases, as you start to see cash generation improve, we should actually have quite a lot of flexibility to make progress on paying down debt. And, once we're on a nice sort of pathway to getting back to somewhere around about that $12 billion level, I think, we'll have a lot more flexibility to start considering other alternatives, which could entail at some point, when we get back to the dividend, get a dividend increase at some point.

Again, at the right time, we'd like to be buying our shares back. We still think they represent really good value and then potentially growth capital. We've intentionally restrained our growth capital.

Our total capital budget this year is $1.7 billion, only $600 million of growth capital. And we're anticipating that for the next couple of years, we'll continue to be pretty constrained in terms of how much we're reinvesting in the business.

And part of that's a function of where the opportunities are as well and the availability of that. So, then the last thing I'd say is we've got good flexibility with the debt maturities we've got coming up and the sort of callable debt we have.

We have an easy line of sight over the next year or two, assuming the cash generation is there. We've got $3.75 billion of debt that we can take care of either because it's callable or it's maturing.

Operator:

And your next question comes from Roger Read with Wells Fargo.

Roger Read:

I guess if we could talk a little bit about the Midstream business, and I'm going to stay away from any DAPL questions, but specific to your commentary about Frac 4 starting up the number of vessels that left during the quarter. And as you think about that business going forward, I mean, some of the forecasts for NGL type production in the U.S. are pretty robust despite maybe a more static oil environment. So, I was just wondering if that's what underpins Frac 4? Or just the volumes are already there. And it's just a question of getting past the whole pandemic issues and moving into that unit.

Tim Roberts:

Roger, this is Tim. Thanks for the question. Actually, the fundamentals for NGLs are still good, albeit, from the quarter standpoint, we had some puts and takes in there with regard to the winter storm.

But the go-forward has — it feels like it's got good strength, partially driven by — and I'll go back to Frac 4 to answer that question.

But really, it's partly it's driven by global demand clearly for LPGs, propanes and butanes and then also growing demand for ethane, both here in the U.S. Gulf Coast, export ethane and just fundamentals in petrochemicals, as Mark just mentioned here, it's strong. And it's growing.

So, in that capacity, NGLs, and especially advantaged NGLs will fill that void. Frac 4, we've got commitments on Frac 4. So actually, we paused while there was some uncertainty in the market last year. And we paused to kind of, okay, let's make sure we're taking care of our liquidity and balance sheet, we paused the project, but we actually are looking to start it up in the second half of this year and get Frac 4 completed, as we continue to build out the hub down at Sweeny.

And again, there is continued demand. We've been running our facility. You noted that on the cargoes that was a record level for the quarter for us. But we still see continued demand for LPGs and see that into the future, as well as PetChems becomes a bigger piece of that export pie versus ResCom.

Roger Read:

Great. Thanks on that. And then my other question, follow-up in the refining business. I understand the guidance and all that. I was just curious how the RINs, the elevated RINs issue is kind of running through the business. I mean, it seems like the outperformance, at least relative to the way we were looking forward in marketing and specialties is probably where the RINs benefit came through. But I just wanted to make sure that you all are more or less balanced on the RIN issue and maybe how you think about that if it maintains these elevated levels kind of hits the rest of the year on capture for refining?

Bob Herman:

This is Bob. Roger, I'll take a shot at that. I think when you look at it, right, so we fully burden our refining results with the cost of the RIN and the run-up in RIN prices. But we believed and continue to believe that the RIN is priced out in the crack. So, as that moves downstream through our various channels of trade, it gets blended. Some of it we get through our liquid blending at our terminals, right, and generate the RINs there for our needs, and it really does pass on downstream to the ultimate consumer. Some of that goes through other channels of trade. We're not exposed on the exports. We had 200,000 barrels a day of exports in the quarter. So, we continue to watch that market, and we really like the fact that we can push a lot of our barrels through our own branded outlets.

Brian Mandell:

And I would just add that in our business, we blend about half, so we create to generate half the RINs we need for our obligation at Phillips 66. And then also in Q1, there was some blend margin. So, RBOB was above ethanol. So, there was some benefit of blend margin in marketing as well.

Operator:

Your next question comes from Doug Leggate with Bank of America.

Doug Leggate:

Good morning, everyone. Guys, I'm sorry to beat on this, Roger kind of stole my thunder a little bit there on the RIN issue. So, I want to dig into this wee bit more, if you don't mind. So, Kevin, I'm looking at — I think, its slide — I've lost the slide number now, the one showing basically the other issue in the crack. It was 4.78 this quarter. This past three or four quarters, you started at negative 2.22 back in 2019, the average is around $0.30, $0.40 negative. And it seems that number has moved up almost lockstep with the RIN. So, I just wonder if you could offer a little bit of color to, I guess, just to Roger's question, but is that what's going on here? Is that the biggest driver of that delta, and what should we be thinking on a go-forward basis because it's obviously denting the capture rate quite a bit?

Kevin Mitchell:

Doug, you're exactly right. The RIN costs, as Bob described that being burdened in refining, that shows up in Other — on that chart. I think, it's slide 9 on the deck. And so, it's a direct hit to the capture rate. So, as the RIN pricing increases, you'll see that take — you'll see that happening there. Now the other comment that when we — over the last year or so where we've been in a depressed margin environment, capture rates just generally are impacted by the fact that you've got costs that flow through here that are on a fixed per barrel basis. So, there's some freight and the like that is a fixed cost per barrel. So, proportionately that becomes a bigger impact takes a bigger hit out of capture than when you're in a more normalized market environment. But RINs in that other is a big element.

Bob Herman:

I think I would add to that kind of quarter-to-quarter you look at a couple of additional things that impacted there and in this particular analysis on the market crack, they end up in Other. One of them is the pricing differentials between Europe and New York Harbor. So, we capture that. And Europe was particularly weak here in the first quarter. So that accounts for a good part of that delta off the fourth quarter.

And then we always get into the timing issues between the Gulf Coast and New York Harbor as we go up Colonial Pipeline. And so, we saw a pretty negative hit there that really is timing as prices run-up, and we'll get it back on the other side eventually. So — but we don't — in this analysis, there's no other place to capture them, so they end up in that Other category.

Doug Leggate:

Understood, guys. I don't want the labor this point, but again, I'm building on Roger's question here, Kevin. It seems to me that even if I look elsewhere in the business, whether marketing or whatever, I can't see where you're getting that back. So, can I just ask you again to clarify, are RINs a net neutral or net negative for Phillips 66?

Bob Herman:

So, at the end of the day, as Brian covered earlier, we blend for about half and then half is other people blending and we're exposed to the commercial market on those RINs. So, net-netit is a negative to us at the end of the day, we do not capture the RIN at the 100% level.

Doug Leggate:

Okay. Thank you for the clarity. My follow-up and maybe this is for Mark, perhaps and welcome, Mark. It's good to hear you on the call. It might not be actually, but I'll see you as one of you guys wants to answer this. It's really more about operational availability. I think Kevin mentioned that you're back early April. I think — I'm not sure about the reference in refining or are we referencing everything. So, after the flooding last year, obviously, the downtime and then you had the storm, what should we think about the mechanical availability of your system, both refining and chemicals and I'll leave it there. Thank you.

Mark Lashier:

I can comment on Chemicals. I think Chemicals is back, excluding normal turnaround activity. They're back, they're available and the plan is to run them basically at full capability.

Kevin Mitchell:

And we guided to 95% O&P utilization for the quarter, so pretty much normal.

Mark Lashier:

Normal operations.

Bob Herman:

On the refining side, we first part of — our first quarter was actually fairly heavy turnaround quarter for us. Some of that carries in here to the first month of the second quarter. But we got a couple of FCCs we're

finishing up as we speak. And we'll really be out of turnaround mode here in the next week to 10 days. And in that, we've kind of got core sailing for the rest of the second quarter and into the third quarter for the gasoline season. So, we feel really good about coming out of the first quarter with all of our kit in shape ready to run. And as we expect gasoline demand to kind of rollback here in the summer season, we're ready to run.

Operator:

Your next question comes from Phil Gresh with JPMorgan.

Phil Gresh:

Hi, good afternoon. One follow-up question on refining, recognizing there are so many one-time factors in the first quarter. Your utilization, you said was the mid-80s here in the second quarter, which sounds pretty similar to your peers. One of your peers commented that in March, they were run rating at a positive operating income. And I recognize the effects of the storms were longer dated for Phillips 66, but would you say that in April or as we move into May, that you feel comfortable that you're also able to achieve that type of level of profitability?

Bob Herman:

I think in April, we still had a lot of turnaround activity going on within the refining system, right? And it was mostly FCC and alky work, so that depresses our market capture and our clean product yields. So, we're still a heavy burden. As I said, we're coming out of that now. As the market continues to improve, our capture rates will improve. I think, we'll see some better crude diffs this quarter, so that should help our market capture. And it's all about kind of where that market moves to. But we're feeling a lot better here as we had head into the month of May than obviously, than we were in the first quarter.

Greg Garland:

Phil, I think too — I mean a lot of our peers report refining and marketing together. And if you add both of those together, I think we feel pretty good.

Phil Gresh:

Okay. No, fair enough and you also expense your turnaround. So, on the chemical side, I mean, I guess, if you look at the first quarter, is there a way to isolate the one-time impacts. The reason I ask is because I mean, this $0.45 full chain margin or you're actually running above that now. So, I'm trying to get a better sense of your profitability there to land in the second quarter. Considering you've said many times, Greg, that $0.25 full chain margin, your annualized EBITDA, would be $2 billion, which would be $500 million quarterly. So, any color on the first quarter or how you think about the second quarter would be really helpful. Thank you.

Kevin Mitchell:

Phil, it's Kevin. There's a significant impact from downtime. So, the lost production impact in the first quarter. And we're not going to quantify that and give that number out. But I think what's fair to say is you look at where the margin environment is today and the projections through the rest of the quarter where operations are.

I think we touched on this earlier in the discussion. I think we feel pretty comfortable saying we'd expect to see that above midcycle EBITDA contribution in the second quarter. And hopefully, some of that sustained into the second half of the year, although you'd normally expect some falloff in margins toward the end of the year. So, we feel pretty optimistic that we should have a strong second quarter in chemicals.

Operator:

Your next question comes from Paul Cheng with Scotiabank.

Paul Cheng:

Kevin, just curious that you talk about the near term, you're trying to get the debt back to the pre-pandemic level around $12 billion. And then you will start looking at alternative or that incremental cash return to the shareholder or that kind of flexibility. And the question is that is $12 billion is really the right number? Given the unpredictable nature of the refining market and all that should we even target a much lower debt level for the company? So that's the first question. Now, that doesn't mean that you should not, at the same time, maybe then increase the shareholder return, but is that one or the other or that we can concurrently to have, continue a portion of the free cash flow being to write down the debt or put on the balance sheet until the balance sheet will be a much lower debt level. So that's the first question.

The second question is that I think this is for maybe Bob and for RIN blend, 50%, that seems really low, given how big your total network is in the U.S. So are we missing something here? That because one we thought given that Phillips 66 today is a combination of Phillips and Conoco, both that have a pretty large wholesale network. And all those contracts historically that will allow you to capture the RIN. So one, we thought that you will blend far more than 50%. So, are we missing something here?

Kevin Mitchell:

Okay. Paul, let me talk to the first question. So you're right that I'd say $12 billion or thereabouts is a sort of near-term objective. That's where we were pre-pandemic, and we'd like to be back on the pathway to that. I would say that on a — as we get to that level, I think there's a — we're continually evaluating what our optimal capital structure looks like. And depending on the state of the business, the growth opportunities, other capital allocation sort of priorities, we will optimize in whatever direction makes sense.

But I'd also say that, while there's — when you come through a period of extreme volatility and depressed margins like we saw in 2020 that may lead you to conclude that maybe we should just permanently run at a lower debt level. I'd also say that there is — the business is growing. And as you expect, the underlying cash generation to increase, you're effectively deleveraging, right, on a sort of debt-to-EBITDA basis as you execute on those growth programs.

And so, I don't know that, I'd get to a point of saying, we need to have an ongoing debt level or an ongoing debt reduction objective. I think we want to get back to that sort of $12 billion level or thereabouts. And the main priority is to maintain that strong investment-grade credit rating.

Greg Garland:

When you look at the cost of debt, I mean you're driven really to have an efficient capital structure in your company. And I think that probably lands us around that $12 billion. So we want to be on a glide slope to that. It's not an absolute target that we're trying to hit here before we get back to increasing our dividend or looking at share repurchases.

I do think that the gating decision for us is really midcycle cash flow. We want to get back to $6 billion to $7 billion of midcycle cash flow. And that creates the optionality for us certainly to invest $1 billion in our sustaining capital to fund our dividend, $1.6 billion and grow that dividend. And then, that leaves us with a lot of optionality, Paul, about further paying down debt or investing more in the company. And we're still comfortable with the guidance around the 60/40 guidance that we've been given over the last few years. And so we still think that's good guidance going forward for our company.

Brian Mandell:

Hi Paul, on the blending RINs question, it is true that we have a large marketing business, both here and overseas in Europe. We also have a large fixed-based operator business, about 900 of those in the U.S. So if you pull out the fixed-based operations business, if you pull out the stores in Europe and you look at how much we blend, don't forget we have 11 refineries in the U.S., so we produce a lot of gasoline. So generally, we run through our stores about a little over 50% to 60% in normal times of the gasoline we produce in our refineries went through our stores. So that's the gasoline that we blend and create those RINs.

Operator:

Your next question comes from Theresa Chen with Barclays.

Theresa Chen:

Hi. Maybe switching gears a bit to your renewable fuels initiative. Can you give us an update on your renewable diesel strategy from here? Have there been any early learnings from the recent hydrotreater conversion at Rodeo? And at this point what are — where are you on the permitting for the full conversion, what are the other key puts and takes in moving that project forward?

Bob Herman:

Hi, Theresa, it's Bob. So on Unit 250, we started it up here early in April after the turnaround to convert the unit to run soybean oil, and so we're running the clean soybean oil out there. And the unit came up first time and has run well. There are some learnings around how to run the unit, and it's a very actuallydifferent process, even though it's the same kit that we had before we shut down that was processing diesel, it's very different for the operators to operate.

It's actually really good for us, there's a learning curve around some of the product — how to handle the product coming off the unit and everything before we get to the big projects. So we'll continue to ramp that unit up into the third quarter here as some of the logistics to feed the unit get — some of those projects get finished and we're able to get to the 9,000 barrels a day of input out there of the soybean oil. So we've also been able to test our logistics supply chain to bring the soybean oil to Rodeo and that's all worked out really well. And that's key for us as we start learning how to feed a much bigger machine in early 2024.

Permitting process in California is progressing. It's a very rote process to work our way through the environmental impact statement. And we have a full-time team working with a full-time team at Contra Costa County, which is the permitting authority. We would expect sometime in the third quarter to have a draft environmental impact statement out there and available, and then you go into the public comment period and you kind of — you kind of work yourself into early next year as the opportunity for that permit to be issued to us and which really then in California, you need a permit in hand to do much on-site construction work.

So in the meantime, we continue to work the final engineering details for all parts of the unit and for the part of the system for the cleanup, the pretreatment unit all that is ongoing. So we feel really good about our timeline and where we're on, and we continue to optimize our schedule and look for opportunities to pull construction forward and get the unit up and running as soon as possible.

Theresa Chen:

Got it. And then on the sustainable aviation fuel front, can you talk about your MoU with Southwest? How that came about? And what kind of economics would this potentially entail? Would it significantly alter the CapEx or scope of the Rodeo project? And with the project as it stands, what percentage of that 800 million gallons do you envision would be dedicated to renewable diesel production versus sustainable aviation fuel, renewable naphtha and such?

Brian Mandell:

Hi, Theresa, this is Brian Mandell. Just to start with, this is an MoU and agreement with Southwest Airlines in terms of jets into and out of California and jets domestically in California. They're the largest airline. So we have an opportunity to work with them, both on public and policymaking, kind of educate policymakers in the public, an opportunity to work on R&D with Southwest Airlines. You may know that we have an energy research and innovation group. I think we're the only ones of our peers that have that where we work on lots of different things, including solid oxide fuel cells, battery technology, solar, we want to also work on sustainable aviation fuel and development of that fuel.

And then think about improving the economics. Right now, if you look at the economics of sustainable aviation fuel versus renewable diesel, renewable diesel makes more sense to produce. So, we need to think about the economics that can come from thinking about how to make it. It can come from the credits. It could come from the price of the fuel. So we have to think through all of that.

And then finally, we're exploring whether we want to have a supply agreement with Southwest Airlines, whether that makes sense. And at the plant, we can produce up to 10,000 barrels a day that will take some capital. We can produce some without any capital going forward. So we're taking a look at whether we want to spend capital, how much we want to make and how it competes with renewable diesel.

Bob Herman:

Yes. As the project is going through its design phase today as is, it will make about 10% sustainable aviation fuel without doing anything. So beyond that, we've got a couple of options you can add a little more kit. You can work on catalyst reformulations. But Brian makes a really good point. To get there, there needs to be a pathway all the way to the jet and there needs to be a price signal to pull it out of the distillate pool and into the sustainable aviation pool.

Brian Mandell:

And just to add to that. If you think about the credits on LCFS credit, if you go the LCFS credit for sustainable aviation fuel, but it's predicated on a lower CI. You get RINs, but the multiplier is 1.6 instead of 1.7 on renewable diesel, and you get a biodiesel tax credit as well. The other thing is when you make SAF, you also make some renewable naphtha and the economics of renewable naphtha are lower. So you have to deal with lower economics associated with naphtha and also the segregation and blending of that naphtha.

Operator:

Your next question comes from Manav Gupta with Credit Suisse.

Manav Gupta:

Hey guys. Just wanted to quickly focus on the feedstock deal that you signed. Again, congrats on getting the feedstock, but my assumption here is this cannot be a majority portion of the feedstock because this is a high CI feedstock and the plant that is coming up was designed for a lower CI feedstock. So what percentage of the feedstock have you actually been able to secure with this contract?

Brian Mandell:

Hey, Manav, this is Brian. So when we think about the plant and ultimately coming up in 2024 and the 50,000 barrels that we'll need. For the first 8,000 barrels, we will need soybean. For the rest of the plant, we will need any form of feedstock. So the plant is predicated on mostly low CI feedstock, we'll be buying used cooking oil, fats, but we'll also be buying some vegetable oils, some higher, some lower feedstock.

And our LP model will kind of dictate to us which feedstock to buy. And it's not just the CI of the feedstock, it's also the transportation, the location, and the cost of the feedstock as the different feedstocks will change in price. It's a benefit of having a hydrotreater in front of the plant, where you can kind of run different feedstocks.

So our goal, too, is to buy, just like we do in our — in the crude and gasoline and diesel market, our commercial group buys much more than we need.

As an example, in the crude market, we buy twice as much crude as the refineries need, and that allows us to optimize the crude. So at any given time, we could think about each refinery and what crude we have available and what crude optimize at that refinery at that time.

And we plan to do the same thing in the feedstock business. So we've been in the feedstock business for a while now. In Hamburg, we've been buying used cooking oil now for almost four years, and we've set up our commercial organization to do just that. We have a business — we have an office in China, an office in Singapore, one in London and one in Houston. We have tanks for used cooking oil in Asia, we have tanks in Europe. And we're moving used cooking all around the world, optimizing that business, and we'll do the same with the other feedstocks as time goes on.

Greg Garland:

And don't forget we're also responsible for supplying feedstock to the Ryze facilities. That's another 10,000 barrels a day, the feed we are responsible for procuring.

Manav Gupta:

Okay. A quick follow-up here is, I think last quarter, I think Jeff went on and explained, which are the areas where the demand is recovering at the fastest pace. So, if you could help us understand where — I mean international jet will remain weak. But other than that in your system, if you go pad-wise, where do you think you have achieved full recovery? And like which are the areas which we can expect would recover in the next three to six months?

Brian Mandell:

I'll take that one. If you take a look at the demand for us, on the diesel side, we're back to 2019 levels on the gasoline side. In the U.S., we're about 5% off. We're further off on diesel and gasoline in Europe where we have business in Germany, about 20% off because they're still on the lockdowns and Austria, about 15% off.

They're coming out of lockdowns on May 18. So we see some sunlight. And then in Switzerland, they're off about 10%, they're open now. I think the U.S. is doing really, really well. If you look at COVID-19 vaccines, 43% of the population has received at least one dose, more than 80% of the population over 65 has received one dose. So we can see a lot of sunlight.

Our view going forward is that we expect given the strength of the economy. We're seeing lots of container ships. The CDC just said that cruise ships can start up in July. We're seeing a lot of strength in the economy. We think these will be up about 2%. We think ultimately gasoline is going to be up about that same amount as people start getting out of the house coming back to work.

Jet, we think — jets down about 25% here in the U.S. We think that will be about 15% as the year goes on. That 15% represents mostly international travel where people are still needing the quarantine, and we think they won't travel as much. But if you think about the gasoline and diesel up 2% roughly and jet down 15%, that whole — net-net that means that we'll be at 2019 levels in the back half of 2021.

And then on top of that if you think about refining capacity, we've shut down over 1 million barrels of refinery capacity since 2019. So we'll be back up to demand levels of 2019 with at least 1 million barrels of refining capacity in the U.S. shut down. So we — that makes us think — we're very bullish in the second half of this year for that reason.

Jeff Dietert:

I think I might just add, when you look at gasoline demand, we are seeing trips to the grocery store, recreational activity has gone back to slightly above pre-COVID-19 levels. And so there's strong demand there. We're seeing a movement out of some of the big cities into suburban areas where people drive more, consume more gasoline. So I think there are positives and negatives, but I think the other thing is, as you look to the summer, hotel reservations are up. It looks like it's going to be a robust travel season for the summer.

Operator:

Your next question comes from Matthew Blair with Tudor, Pickering, Holt.

Matthew Blair:

Hey. Good morning everyone. I just had a follow-up on the renewable diesel conversation. Currently, I don't see an LCFS fuel pathway for Phillips 66. So I just wanted to clarify whether you will be capturing an LCFS credit on this initial 120 million gallons?

Bob Herman

Yes, we will. So the way that works that is — you have to come up and run and demonstrate your capability and where your feedstock is coming from, and they actually assign you kind of an average CI for the first two quarters of operations.

So we will capture an LCFS on the difference between the statutory level and that assigned CI. And then, as we run and we'll demonstrate that the actual feedstocks we're providing are a lower CI than the one assigned will ramp kind of into over the next two quarters, a larger LCFS benefit than we're getting today.

So it's a process that's prescribed by carbon. And we don't have any choice but to follow it. And so, we're in the middle of that now since we're operating.

Brian Mandell:

And that CI difference is around 9 or 10... CI points. So, we expect after the first couple of quarters of running that machine that we'll get a CI about 9 or 10 points better than we're currently getting.

Jeff Dietert:

And so we'll capture, just to be clear, LCFS, RINs and BTC with these barrels.

Greg Garland:

Yes.

Matthew Blair:

Sounds good. And then, as a follow-up, do you have an opinion on why LCFS credits have sold off over the past month? Do you think it’s maybe like a seasonal issue around the annual compliance date? Or do you have concerns that the overall California LCFS market is becoming oversupplied?

Brian Mandell:

No. We think it's utilization, with utilization down, there's less demand. If you look at the forward curve, it's a contango so the forward curve is higher. That makes sense because the obligation increases every year. So we would expect it to come back up as the utilization rate rises in California.

Jeff Dietert:

California has announced opening up in mid-June, which should support demand. We are seeing a correlation between the increase in vaccines and the increase in vehicle models traveled and demand for gasoline.

Operator:

Your next question comes from Jason Gabelman with Cowen.

Jason Gabelman:

Hey, thanks. So I'd like to go back to the RIN discussion because it seems like an important one. I'm just trying to understand the ability to, I guess pass through the RIN cost to the consumer within your marketing business.

And what I'm thinking is, does the kind of net ring cost of fill-ups go up during periods of weak demand like during COVID-19, just because it's more difficult to pass through the cost to the customer. So is that kind of creating some volatility in understanding what your RIN exposure is.

And then my second question is just a simple one. I was hoping if you could provide the OpEx impact to the refining business from Uri. Thanks.

Brian Mandell:

So, Jason, we think that we passed the RIN to the customer. I think it's true that during times of low demand, marketing margins suffer because we have to compete to sell our barrels. But in terms of the RIN, we think the RIN gets passed to the consumer ultimately.

Jason Gabelman:

Okay.

Bob Herman

Your second question was around the cost to the refining system from the Texas winter storm. So we saw a pretty significant fuel gas cost, electricity cost across our system. It wasn't just the four plants that were heavily affected in the — kind of in the Mid-Con and the U.S. Gulf Coast, but because of just the way gas pricing works, right, we saw effects kind of across our system.

So if you look at the impact to us in kind of our total operations in there, we're up in that kind of $175 million to $200 million range for increased utility costs and a little bit of cost increase to fixed broken pipes and things. We really didn't have that much damage, most of it we saw in the utility sector.

Operator:

We have reached the end of today's call. I will now turn the call back over to Jeff.

Jeff Dietert:

All right. Thank you very much for your time and your interest in Phillips 66. Please contact Shannon or me with any follow-up questions, we're happy to help.

Operator:

Thank you, ladies and gentlemen. This concludes today's conference. You may now disconnect.