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Phillips 66 (PSX)

Q2 2022 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Welcome to the second quarter 2022 Phillips 66 earnings conference call. My name is Joanna, 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

Vice President-Investor Relations, Phillips 66

Good morning and welcome to Phillips 66 second quarter earnings conference call. Participants on today's call will include Mark Lashier, President and CEO; Kevin Mitchell, EVP and CFO; Brian Mandell, EVP, Marketing and Commercial; Tim Roberts, EVP, Midstream and Rich Harbison, SVP, Refining.

Today's presentation materials 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'll be making forward-looking statements during today's call. 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.

Before we begin our discussion, I would like to highlight that we will be hosting an Investor Day in New York on November 9.

With that, I'll turn it over to Mark.

Mark E. Lashier

President, Chief Executive Officer & Director, Phillips 66

Thanks, Jeff. It's great to be here with you today, as President and CEO. As I shared with our employees, it's an honor and a privilege to be taking on this role. And I'm happy to be a part of the strong leadership team and humbled by the opportunity to lead such a great company.

I'd also like to introduce Rich Harbison, our new Senior Vice President of Refining. Rich has over 30 years of experience in a variety of leadership roles across our refining, pipeline and terminal organizations. Most recently, he was Vice President of the San Francisco Refinery, where he oversaw the Rodeo Renewed project.

Our second quarter results reflect the strong market environment driven by a tight global supply and demand balance. We're focused on reliably providing critical energy products, including transportation fuels to meet demand. We've maintained strong operations in successfully completing our spring turnaround activities early in the second quarter. Even with global refineries running near max capacities, gasoline and distillate inventories remain low, supporting elevated refining margins.

In the second quarter, we had adjusted earnings of $3.3 billion or $6.77 per share. We generated $1.8 billion in operating cash flow. Excluding working capital, operating cash flow was $3.6 billion. We returned $533 million to our shareholders through dividends and share repurchases.

We resumed our share repurchase program in the second quarter and remain committed to a secure, competitive and growing dividend. In May, we raised our dividend 5% to $0.97 per share. We've increased the dividend 11 times since our inception in 2012, resulting in an 18% compound annual growth rate.

Our strategy remains consistent, supported by a strong foundation of operating excellence and a high-performing organization. We're focused on strategic return-enhancing growth investments in Midstream, Chemicals and Emerging Energy while selectively investing to increase returns in Refining and Marketing and Specialties.

We continue to target a long-term capital allocation framework of 60% reinvestment in the business and 40% cash returned to shareholders in the form of dividends and share repurchases. We've been successful in reducing pandemic debt, including paying down $1.5 billion of debt during the second quarter. In addition, we believe higher cash levels are prudent, given the current uncertain economic environment.

We're executing an enterprise-wide business transformation to achieve sustained annual cost savings of at least $700 million. David Erfert, Senior Vice President and Chief Transformation Officer, has been leading the effort across our organization with engagement from over 1,000 employees. Initiatives are being implemented to position us for the future and ensure we remain competitive in any economic scenario. We look forward to sharing more details on our business transformation at our Investor Day in November.

During the quarter, we continued to focus on operating excellence and advancing our strategic initiatives. In Midstream, at the Sweeny Hub, we expect Frac 4 to start up late this quarter. The total project cost for Frac 4 is expected to be approximately $525 million.

CPChem is pursuing a portfolio of high return projects, enhancing its asset base as well as optimizing its existing operations. CPChem's total capital budget for 2022 is $1.4 billion, of which $1 billion is for growth projects with average expected returns above 20%. This includes growing its normal alpha olefins business with a second world-scale unit to produce 1-hexene, a critical component of high-performance polyethylene. Construction is underway on the 586 million pounds per year unit located in Old Ocean, Texas.

CPChem is also building a new propylene splitter at its Cedar Bayou facility, which will expand its capacity by 1 billion pounds per year. Both the 1-hexene and propylene splitter projects are expected to start-up in the second half of 2023. Recently, CPChem announced plans to double its polyalphaolefins capacity in Belgium to approximately 265 million pounds per year, with start-up expected in 2024.

CPChem continues to develop two world-scale petrochemical facilities on the US Gulf Coast and in Ras Laffan, Qatar. A final investment decision for the US Gulf Coast project is expected this year.

In Refining, we made a final investment decision to move forward with our Rodeo Renewed project to convert our San Francisco refinery into one of the world's largest renewable fuels facilities. The project is expected to cost approximately $850 million and begin commercial operations in the first quarter of 2024. Upon completion, Rodeo will have over 50,000 barrels per day of renewable fuels production capacity.

In addition, the conversion is projected to reduce life cycle carbon emissions by approximately 65% or the equivalent of permanently removing 1.4 million cars from California roads.

In July, we formed JET H2 Energy Austria, a 50-50 joint venture with H2 Energy Europe to develop up to 250 retail hydrogen refueling stations across Germany, Austria and Denmark by 2026.

Recently, we published our 2022 Sustainability Report, providing a comprehensive look at our actions to both prepare Phillips 66 to thrive in the energy future and deliver on our commitment to being one of the industry's best operators. The report includes a detailed analysis of the company's climate-related risks and opportunities as well as performance data on various environmental, social and governance matters.

Before we review the financial results, we'd like to recognize our employees' commitment to operating excellence. We're honored that our Midstream business was awarded the American Petroleum Institute's Distinguished Pipeline Safety Award for large operators for the second consecutive year.

In addition, Midstream received the Platinum Safety Award in the large company division from the International Liquid Terminals Association. Congratulations to all the people working at these facilities. Well done.

Now I'll turn the call over to Kevin to review the financial results.

Kevin J. Mitchell

Executive Vice President-Finance & Chief Financial Officer, Phillips 66

Thank you, Mark, and hello, everyone.

Starting with an overview on slide 4, we summarized our financial results for the second quarter. Adjusted earnings were $3.3 billion or $6.77 per share, a $240 million decrease in the fair value of our investment in NOVONIX reduced earnings per share by $0.38. We generated $1.8 billion of operating cash flow, including a working capital use of $1.8 billion.

Cash distributions from equity affiliates were $527 million. Capital spending for the quarter was $376 million, including $167 million for growth projects. We returned $533 million to shareholders through $460 million of dividends and $66 million of share repurchases. We ended the quarter with 481 million shares outstanding.

Moving to slide 5, this slide highlights the change in adjusted results by segment from the first quarter to the second quarter. During the period, adjusted earnings increased $2.7 billion, with a substantial improvement in Refining.

Slide 6 shows our Midstream results. Second quarter adjusted pre-tax income was $292 million compared with $242 million in the previous quarter. Transportation contributed adjusted pre-tax income of $250 million, down $28 million from the prior quarter. The decrease was mainly due to lower equity earnings, driven by reduced Bakken crude volumes associated with winter storm impacts.

NGL and Other adjusted pre-tax income was $152 million compared with $91 million in the first quarter. The increase was primarily due to improved margins and volumes at the Sweeny Hub. The margin improvement includes unfavorable inventory impacts in the previous quarter. In addition, we had higher Sand Hills pipeline equity earnings in the second quarter. The fractionators at the Sweeny Hub averaged a record 441,000 barrels per day, and the Freeport LPG export facility loaded 240,000 barrels per day in the second quarter.

DCP Midstream adjusted pre-tax income of $130 million was up $99 million from the previous quarter, mainly driven by improved gathering and processing results and hedging impacts. The hedge gain recognized in the second quarter was approximately $30 million compared with a hedge loss of approximately $50 million in the first quarter. Our NOVONIX investment is marked to market at the end of each reporting period. The fair value of the

investment, including foreign exchange impacts, decreased $240 million in the second quarter compared to a decrease of $158 million in the first quarter.

Turning to Chemicals on slide 7, Chemicals' second quarter adjusted pre-tax income of $273 million was down $123 million from the prior quarter. Olefins and polyolefins adjusted pre-tax income was $216 million. The $161 million decrease from the previous quarter was primarily due to lower margins resulting from higher feedstock costs as well as increased utility and turnaround costs. Global O&P utilization was 94% for the quarter.

Adjusted pre-tax income for SA&S was $59 million, up $27 million from the prior quarter. The increase was mainly due to improved margins on benzene and specialty chemicals as well as improved styrene results. The $11 million improvement in Other mainly reflects lower employee-related expenses and higher capitalized interest related to growth projects. During the second quarter, we received $260 million in cash distributions from CPChem.

Turning to Refining on slide 8, Refining's second quarter adjusted pre-tax income was $3.1 billion, up from $140 million in the first quarter. The improvement was primarily due to higher realized margins across all regions. Realized margins increased by 168% to $28.31 per barrel. Pre-tax turnaround costs were $223 million, up from $102 million in the prior quarter. Crude utilization was 90% in the second quarter, and clean product yield was 83%.

Slide 9 covers market capture. Our composite global 3:2:1 market crack for the second quarter was $46.72 per barrel compared to $21.93 per barrel in the first quarter. Realized margin was $28.31 per barrel and resulted in an overall market capture of 61%. Market capture in the previous quarter was 48%. Market capture is impacted by the configuration of our refineries. We have a higher distillate yield and a lower gasoline yield than the market indicator. During the quarter, the distillate crack was $61.38 per barrel, and the gasoline crack was $39.52 per barrel. The configuration impact as a percentage of the market crack was similar to first quarter. Losses from secondary products of $3.03 per barrel were in line with the prior quarter.

Our feedstock loss of $1.46 per barrel declined $2.47 per barrel from the previous quarter due to narrowing Canadian crude differentials. The other category reduced realized margins by $7.48 per barrel. This category includes RINs, lean product realizations, freight costs, and inventory impacts.

Moving to Marketing & Specialties on slide 10, adjusted second quarter pre-tax income was $765 million compared with $316 million in the prior quarter. Marketing & Other increased $453 million from the first quarter. This was primarily due to higher realized fuel margins, including inventory impacts. Refined product exports in the second quarter were 153,000 barrels per day. Specialties generated second quarter adjusted pre-tax income of $109 million, in line with the previous quarter.

Slide 11 shows the change in cash during the second quarter. We started the quarter with a $3.3 billion cash balance. Cash from operations was $3.6 billion, excluding working capital. There was a working capital use of $1.8 billion, mainly reflecting an increase in accounts receivable due to higher product prices and timing of sales. We repaid $1.5 billion of debt, lowering our net debt-to-capital ratio to below 30%, the lowest it has been since the fourth quarter of 2019. In addition, we funded $376 million of capital spending and returned $533 million to shareholders. Our ending cash balance was $2.8 billion.

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

In Chemicals, we expect the third quarter global O&P utilization rate to be in the mid-90s. In refining, we expect the third quarter worldwide crude utilization rate to be in the low to mid-90s, and pre-tax turnaround expenses to be between $260 million and $290 million. We expect full-year pre-tax turnaround expenses to be at the lower end of our $800 million to $900 million guidance. We anticipate third quarter corporate and other costs to come in between $210 million and $230 million pre-tax.

Now we will open the line for questions.

QUESTION AND ANSWER SECTION

Operator: Thank you. We will now begin the question-and-answer session. [Operator Instructions] Neil Mehta from Goldman Sachs, please go ahead. Your line is open.

Neil Mehta
Analyst, Goldman Sachs & Co. LLC

Q

Yes, good morning team. I wanted to kick off with you, Mark, on your perspective as the new CEO, and congratulations to you, again, on the role. And one of the areas that you've talked about in the past that you think there is an opportunity gap around earnings is to improve the profitability of the Refining segment and some of that came through this quarter, for sure. So, I just would love to hear how you're seeing the business transformation. What are the things that you're doing strategically on the ground? And how should we as an investment community, evaluate that progress?

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Thank you, Neil. And it's a great question and I appreciate that, there's a number of dimensions that we're looking at. You mentioned our business transformation. At a high level, we've mentioned we're targeting over $700 million in expense reduction, and we're quite confident in that number. There's probably a little upside there, but we're transitioning from analyzing what we can do, identifying what we can do to executing. So we're launching into execution as we speak.

When you think about Refining, cost is a big piece of what we're doing in Refining and it's a big piece of that whole $700 million. We're looking at things like standardizing across our Refining fleet, how we do things. We're looking at centralizing many of the support functions for our refineries, all the way out to looking at how we do maintenance, how we operate and optimize using digital, things that we've implemented to do better maintenance at a lower cost to optimize more aggressively, to identify opportunities quicker.

And when you think about the margin capture, it really boils down to utilization, yield, reliability, things like that. And we've got things in flight to address reliability, things to enhance the yields of what we produce and certainly, maximize our ability to utilize those assets.

All of that – some of that was in flight before business transformation hit, but all of that will come through in business transformation. And beyond the cost element, we're really pushing the organization from the bottom up to identify opportunities. The folks out on the frontline have a big role in identifying the things that they think are inefficient in what we do and how we can capture those efficiencies and change the way we work.

And when you layer on that, the digital things we're putting in place from Wi-Fi in our facilities to different kinds of sensors on our pumps and different processing equipment so we can better monitor them in real-time, it's all going to add up to better utilization, pushing that operating envelope even further. And that will enhance our reliability and our yields as we go forward. So, there's a number of dimensions that we're pressing on, Neil, and we think they'll all contribute to much stronger competitive performance in our Refining sector.

Neil Mehta
Analyst, Goldman Sachs & Co. LLC

Q

Yes, thanks so much. And maybe the follow-up to that is a little bit more of a near term question is how should we think about the refining market conditions right now impacting your 3Q profitability? You're guiding to crude utilization, which is pretty good, low to mid-90s, diesel is trading above gasoline, WCS is winding out. In theory, this should be a good opportunity set for your Refining business.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Yes, Neil, we're in alignment in that. We think the fundamentals are strong for our kit going forward and we need to operate very well. We will see some turnarounds come back into the picture later in the year, later in the quarter, but we see an opportunity to run strong. Our assets are in really good shape.

And the crude diffs are certainly moving in our favor, and our ability to outperform on distillates versus gasoline will be strong. If you look at the fundamentals around the cost curve between the US and Europe, if you look at the fundamentals around where inventories are, we just can't build any inventory with prompt demand where it is. We're bullish on that outlook as well.

Neil Mehta
Analyst, Goldman Sachs & Co. LLC

Q

Thank you.

Operator: Doug Leggate from Bank of America, please go ahead. Your line is open.

Doug Leggate
Analyst, BofA Securities, Inc.

Q

Thank you. Good morning, everyone. And again, Mark, welcome to the hot seat. I guess it's an interesting time for you for sure.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Thanks, Doug.

Doug Leggate
Analyst, BofA Securities, Inc.

Q

This morning, I wonder if I can ask a macro question and a specific question to you on the quarter relating to the relative profitability of Europe compared to your US business. So, my macro question is that ExxonMobil, this morning, kind of laid out their prognosis for capacity additions over the next year or two. And I'm just curious if you could share your thoughts on how you see, if there is such a thing, a new normal for this business going forward.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66
A

You broke up a little bit, Doug. I think the first part of the question was about our view on capacity additions. I'm going to have Jeff address that. And then we may have you repeat the second half because you broke up a little bit.

Doug Leggate
Analyst, BofA Securities, Inc.
Q

Sure, no worries. Thank you.

Jeff Dietert
Vice President-Investor Relations, Phillips 66
A

Yes. Doug, we have between 1.3 million and 1.5 million barrels a day of capacity growth per year in the 2022, 2023, 2024 timeframe. Now that will be offset by about half as much capacity that's announced rationalizations that will be coming out of the market, including our Rodeo Renewed that we're converting to a renewable diesel facility. So, there will be some capacity growth, but the market's tight, from the cracks in the marketplace and the inventories today currently.

Doug Leggate
Analyst, BofA Securities, Inc.
Q

Okay. So Jeff, I want to…

Jeff Dietert
Vice President-Investor Relations, Phillips 66
A

You're breaking up a little bit, Doug. Come at us again.

Doug Leggate
Analyst, BofA Securities, Inc.
Q

Okay, I apologize. My phone signal is not the best. So I'll try my follow-up. I'm interested in the relative profitability of Humber relative to your US business. So I'm thinking specifically about the cost of natural gas in Europe is obviously lifting the cost of European refining. You've got a unique insight to that. So I'm just wondering if you could share your perspective on how Humber is doing in this environment. And where you see the quarter also perhaps relative to the other European refiners?

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66
A

I think at a high level, we're happy with Humber's performance. They're doing a number of things really well. They're profitable. I think Rich can provide a little more color on our competitive position there.

Richard G. Harbison
Senior Vice President, Refining, Phillips 66
A

Yes, certainly. Thanks, Mark. And Doug, good question. And certainly, it's on the minds of a lot of folks right now, the price of natural gas in the European market has gone quite high. Fortunately, for us, the Humber facility has a very mature energy stewardship program. It's been in place for over 20 years in that marketplace. They're a very efficient operation, actually the lowest CO2 emitter in the UK refining systems.

They're a very low consumer of purchased natural gas. And in a high natural gas price environment, obviously, there's some impact on their business, right, as far as electricity costs that are externally provided and chemical costs in those areas, which are consistent with the broader industry as well. But primarily, where Humber's advantage is in the operation, is that fuel efficiency. And they buy very little to no natural gas for fuel gas supply to the facility.

Doug Leggate
Analyst, BofA Securities, Inc.

Q

And on hydrogen for hydro-treating?

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

Yeah. And they consume a little bit of hydrogen, but mostly self-generated inside the facility. And that hydrogen price will be impacted a little bit by the natural gas, that's right.

Doug Leggate
Analyst, BofA Securities, Inc.

Q

Good point, but I guess I was looking for your perspective on relative clearing costs for Europe versus the US, obviously, Humber's advantaged. But generically, how do you see the US versus European trade-off as it relates to the incremental cost of supply, I guess, is what I was getting at?

Brian Mandell
Senior Vice President, Refining, Phillips 66

A

Generally, for most refiners, we think somewhere in the $10 to $12 range, we're advantaged versus those refiners, Rich pointed out Humber and where that stands versus other refiners in the market.

Operator: Roger Read from Wells Fargo. Please go ahead. Your line is open.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

Yeah, thank you. Good morning.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Good morning.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

And Mark, welcome to the role.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Thanks, Roger.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

Good luck for everything. Maybe to sticking a little bit to the forward look, I mean, I know everybody worries about gasoline demand taking a hit. But as you all mentioned many times, diesel is a bigger part of your kit. And as we look towards the following winter, where do you think we are now in terms of broadly speaking, diesel production, sensitivity, if any, that you've seen on price? And then between either max diesel or max jet or max distillate versus gasoline, how that setup looks for you?

Brian Mandell
Executive Vice President-Marketing and Commercial, Phillips 66

A

Well, thanks, Roger. Maybe I'll take that. This is Brian. It's hard to see a solver for distillate coming up in the winter. We're at low inventories. If you look in the US, we're at minus 20% versus 2015 to 2019 averages. We're heading into a turnaround season. Demand is strong. We've seen demand better than 2019 currently. Refiners are running now max distillate, and we have in every pad jet RIN adjusted over distillate prices.

We're heading into harvest season. Cost to produce in Europe, as we just talked about, is expensive versus the US, so they're not going to be able to help much. We think there's about 150,000 barrels of Russian distillate off the market, which doesn't help much either. So, I think as you pointed out, we're distillate-heavy in our system. I think that's going to be a good thing going forward, given our view of distillate.

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

Thanks for that. And then, also leaning into the overall European question. As you look across all of your different operations, so I'm thinking catalysts and some of the specific, maybe metering or valves equipment, within the Refining segment, similar in parts and Midstream in terms of valves and measurement and some of that maybe in chemicals.

Do you have any specific exposure to Northern European countries that could face some significant power constraints and thus, some industrial curtailment over the next several quarters, in such a way that it could affect any of your operations, long lead time items you might need for turnarounds? I'm just trying to sort of gauge the risk, given all the other supply chain and logistics issues we've seen over the last year or two.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

So what I think the question is, Roger, are there specific suppliers, specific manufacturers in Europe that we might have exposure to that could be disrupted as they cut back on natural gas and their ability to manufacture. Is that the question?

Roger D. Read
Analyst, Wells Fargo Securities LLC

Q

Yes, sir.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Rich, do you have a perspective on that?

Richard G. Harbison
Senior Vice President, Refining, Phillips 66
A

We're certainly seeing supply chain restrictions, lead times taking a little bit longer. But there's no specific supplier that we've identified at this point in time that has us concerned about our ability to continue to conduct our business. In some cases, maybe we're splitting suppliers and are moving to others. But we don't anticipate inside the refining organization any significant supply chain issues at this point.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66
A

I don't think we have any single point of failure in securing any equipment that we might need to keep our operations going.

Roger D. Read
Analyst, Wells Fargo Securities LLC
Q

Great, thank you.

Operator: Ryan Todd from Piper Sandler, please go ahead. Your line is open.

Ryan M. Todd
Analyst, Piper Sandler & Co.
Q

Thanks, maybe a follow-up on some earlier questions. As you think about capture trends on the Refining side, there have been various things that have been varying degrees of overhang in the first half of the year. As you look into the third quarter, as you think about things like widening crude differentials, the trends in secondary product dynamics, backwardation, et cetera, how would you think about some of the backdrop in terms of refining capture and where we're trending 3Q versus 2Q and 1Q?

Richard G. Harbison
Senior Vice President, Refining, Phillips 66
A

This is Rich Harbison here. Market capture in refining, we had a nice bump over the first quarter, 61% market capture, certainly improved over the first quarter. We're working to continue this trajectory. We'll be subject to some planned maintenance on the backside of the next quarter that has some potential to impact that market capture. But really, our key is focused on, as Mark indicated earlier in his opening comments, it's around the reliability programs that we're implementing and improving our utilization of the existing facilities, while we also focus on turning our products into the highest value, which are generally clean product yield improvements.

So we think that's looking directionally good for us in the third quarter and also the early indications of the widening light/heavy crude differential are also a good tailwind for our kit.

Jeff Dietert
Vice President-Investor Relations, Phillips 66
A

I think one of the things we identified in the first quarter was just some timing issues associated with the rapid increase in crude price. Crude price continued to increase in 2Q, so the direction of crude price could have some influence on market capture, depending on which direction it moves.

Ryan M. Todd
Analyst, Piper Sandler & Co.

Q

Thank you. And maybe shifting gears a little bit on the Chemicals side, any comments you can provide on Chemicals macro environment? What are you seeing on demand at the margin? The shutdowns in China have been an impact on the margin in terms of demand there. Globally, are you seeing any signs of kind of slowdown in demand for Chemicals products?

And then obviously, you have some potential FID on a major expansion later this year. So as you think about the macro backdrop over the next couple of quarters, what does it look like to you? And then as you think over the next few years as a backdrop for potential investments, any thoughts on where we are in the chemical cycle there and how that will inform things going forward?

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Ryan, I'll cover the macro, then Tim Roberts, he sits on the CPChem Board of Directors, and they'll be looking at those FID opportunities. I'll ask him to provide color on the mega projects. But from a macro perspective, CPChem is seeing, frankly, really strong demand for most of their products, in particularly polyethylene.

The challenge in the polyethylene chain is with what's going on in the energy sector. Feedstock costs have gone up. And in spite of pretty significant increases in demand, there's more capacity – new capacity coming on in North America, and they continue to face export challenges. So North American demand has been strong. European demand has been very strong. And you see European producers doing quite well because North America is bottled up on logistics getting into Europe to take advantage of that. So you're seeing that captured by European producers, by Middle East producers. Asia is still slow. If Asia comes back, that will add some upside to things in a number of dimensions.

So if you look at their Specialty Chemicals business, their Performance Pipe business, they're having record years. And even their Styrenics business, their exposure there I think is benefiting from relative lower abundant naphtha, abundant benzene driving better values in some of their aromatics products. So they're seeing pretty robust demand across the board for now. So with that, Tim, do you want to pick up on the major projects?

Timothy D. Roberts
Executive Vice President-Midstream, Phillips 66

A

Yes. Sounds good. Thanks, Mark. From the standpoint of FID, we still anticipate, in the fourth quarter making a decision on the project. As probably we've said before, all the permitting is complete. All the typical you would consider AFD work, which is before pre-sanctioning, has been underway. So some civil work has already started, along with long lead items, some compressors, extruders, some of those things, also in an effort to mitigate any inflationary issues that you may encounter. So overall, a big project and moving forward to a decision point here in the fourth quarter. So we feel good about that project.

I will talk about RLPP just real quick. That way we cover that, so the two biggest items we've got. Awaiting EPC bids on that particular project. Again, that's a 30%/70% CPChem/QatarEnergy joint venture. And so that's moving along. And we anticipate a 2023 FID decision for that particular project, but it's also advancing as per the stage gates we have on projects of this size.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Both those projects will scale. If you think about Gulf Coast One, it was 1.5 million tons plus derivatives. These will be 2 million tons plus derivatives, and they're going to both leverage off of considerable advantaged infrastructure on the Gulf Coast and, of course in Ras Laffan in Qatar. So, they've got a substantial capital advantage, which lowers their exposure to any inflationary pressure. And they've done, as Tim referenced, things to mitigate that inflationary pressure. CPChem, along with QatarEnergy and the owners of CPChem, have a very diligent, deliberate process to go through to ensure that we're mitigating those risks and positioning to take advantage in the best way, what the market – the long-term market fundamentals will offer them. And both those projects will be off-balance sheet project financed. Kevin, you've got a perspective there. Why don't you talk about that?

Kevin J. Mitchell
Executive Vice President-Finance & Chief Financial Officer, Phillips 66

A

Yes, I will because it's an important point. Two projects of that scale running. Obviously, that's a big capital outlay. But, when you factor in they're both joint ventures, so CPChem is 51% of the Gulf Coast project, 30% of the Middle East project. And then both will be subject to project financing. On the Gulf Coast 1 – sorry, Gulf Coast 2 project, the financing is being actively worked at this point to get that ready for FID. But the expectation is if we think of about 50% project financing, combined with the fact that CPChem's ownership is at 51% on one and 30% on the other, that dramatically reduces the cash outlay that CPChem will have as they're funding the construction of those projects.

Ryan M. Todd
Analyst, Piper Sandler & Co.

Q

Great. Thank you.

Operator: Manav Gupta from Credit Suisse. Please go ahead. Your line is open.

Manav Gupta
Analyst, Credit Suisse Securities (USA) LLC

Q

Hey, guys. So, I'm just running back some data, and I noticed that traditionally, if you made $100 in your Gulf Coast, you made probably $200 to $300 on your Central Corridor at least. So obviously, this quarter was – seems like a heavy turnaround quarter for Central Corridor. And I'm just trying to understand, was it basically the turnaround because of which the Central Corridor was below the Gulf Coast? Or is there more to it because two regions where you do make needle coke are Atlantic Basin and Gulf Coast. So, is needle coke pushing up the earnings of those two regions relative to Central Corridor where you actually maybe don't make needle coke? So if you could help us understand those dynamics.

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

Hi. This is Rich Harbison again. The primary difference between those two regions was driven by turnaround activity. It's really as simple as that. We were down for a good part of the quarter at a couple of facilities in the Mid-Continent area.

Manav Gupta
Analyst, Credit Suisse Securities (USA) LLC

Q

So as you run hard over in 3Q, the equation reverses to historical ratios roughly?

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

That would be our hope.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Depends on what the market does, but yeah.

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

Yeah.

Manav Gupta
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. And a quick question here is, I think you guys do want to build on your clean fuel or green energy or new energy business, and you have the balance sheet. And I'm just trying to understand, look, if the right opportunities arise, would you be open to more deals like NOVONIX where you become JV partners or partial owners and use your balance sheet to try and grow your green energy business? Or from this point on, mostly it'd be organic investments in that business? Thank you.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Yeah, Manav, that's a great question. We've got four pillars in that business that we're trying to establish ourselves. Of course, the nearest and the most actionable is around renewable diesel, sustainable aviation fuel, converting assets that we have to produce things that are very, very close to us. The longer-term things around batteries and carbon capture and hydrogen, you'll see us making more modest investments to learn how to take on those things. Across the whole spectrum of these things, we're going to take a very disciplined approach around capital investment. We've got good line of sight on Rodeo. It's a high-return project. It's going to be the lowest capital cost per gallon of any renewable diesel facility that we're aware of. We really like that project. It's in the right marketplace. It's got the right logistics and feedstock access.

As you look further out in time, you look at the NOVONIX investment, it was a modest investment. We won't invest in a big way in assets in – to chase batteries or to chase hydrogen until we see line of sight on good returns, returns that our investors will be happy with. But we do have to take steps now to understand how you can create value in those value chains. Where is the right position for us to establish a competitive advantage and bring the right products, the right energies to the market that needs them? So we are not adverse to doing inorganic things, if it makes sense. And as we've demonstrated, we've entered into joint ventures to help explore these opportunities, or we'll go out organically on our own in areas that are very close to our wheelhouse that we believe we can establish and capture advantage and capture real value in.

Kevin J. Mitchell
Executive Vice President-Finance & Chief Financial Officer, Phillips 66

A

And Manav, it's Kevin. Just to reinforce the point, we have a balance sheet but we are going to be very diligent in how we use that balance sheet.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Yeah.

Kevin J. Mitchell
Executive Vice President-Finance & Chief Financial Officer, Phillips 66

A

And so our expectation is that, if we're putting our balance sheet to work, we're expecting returns that meet all of our typical thresholds as we've talked about in the past.

Manav Gupta
Analyst, Credit Suisse Securities (USA) LLC

Q

Okay. Thank you, guys.

Operator: Theresa Chen from Barclays, please go ahead. Your line is open.

Theresa Chen
Analyst, Barclays Capital, Inc.

Q

Hi, there. Thank you for taking my questions. First, I wanted to touch on the Marketing segment. Just seeing that really strong contribution this quarter and the resilient demand reflected in the volumes, can you talk about what is happening in real time in that segment? And if this is a new run rate or were there discrete items that boosted contribution in second quarter?

Brian Mandell
Executive Vice President-Marketing and Commercial, Phillips 66

A

Theresa, this is Brian. I would start by saying that Marketing did do well in the quarter, in large part because of market volatility in all the markets that we market in. And also, because of the seasonality, Q2 is typically a better time for Marketing than Q1. And we benefit from having a diverse portfolio, both geographically, we have operations here in the US and in Western Europe, and by marketing to a number of customer channels, unbranded, branded and retail. But I would say, besides market volatility and seasonality, we saw strength in a number of areas across the portfolio.

I'll give you some examples. In the US branded business, we sell product to discount retailers who perform very well, given the current market. In Germany, volumes recovered in part through the benefit of a German tax holiday, which started at the beginning of June and will end at the end of August.

Also, our Austrian marketing business benefited from supply constraints related to Austria's only refinery, which is currently running at 20%. We supply our marketing from alternative supply destinations.

And I think finally, I'd say across the portfolio, retail, which we've been building in the US and have overseas performed really well, including inside sales of convenience store products. So, we saw a number of opportunities to help the business, including, of course, volatility and seasonality.

Kevin J. Mitchell
Executive Vice President-Finance & Chief Financial Officer, Phillips 66

A

Theresa, it's Kevin. I would just also add that in the quarter, there's probably about $80 million of gains that are associated with inventory-related movements that we would expect that to come back in the second half of the year, realistically third quarter. So, there's that component that is included in those results.

Theresa Chen
Analyst, Barclays Capital, Inc.

Q

Got it. Thank you. And turning to Midstream, on the heels of a major buyer in one of the key Mid-Con fractionators and your fractionation footprint on the Gulf Coast, can you tell us if this could potentially provide a tailwind for your frac volumes in the second half as those Y-grade barrels will likely need to be diverted elsewhere for fractionation?

Timothy D. Roberts
Executive Vice President-Midstream, Phillips 66

A

Great question on that, Theresa, yeah, unfortunate incident up at Medford and under the Conway Hub. Probably let me context it this way is the answer is yes. But behind that, I would say that up in Conway, there's about 600,000 barrels of frac capacity out there currently. Of that, Medford is about 220,000 barrels of it, so a significant piece of that particular hub. So with that not operating, currently, that's put pressure on Conway, so Conway is effectively tight. There's no room for any more barrels there.

So instead of moving purities from Conway down to the US Gulf Coast, you're seeing Y-grade move down. So the Y-grade is looking for a home as well, both at Mont Belvieu and I would say our facility but we've been running full out.

So we're really not going to get volume though because we may get some margin help because it's tight enough in Mont Belvieu and tight enough, obviously, in – down at our shop. And at Conway, you'll see the tightening of the market will put some pressure on the system itself.

Now what I will tell you is that this is a temporary moment in time because you've got five fracs coming on board in the next 18 months, about 700,000 barrels a day. Of that, 150,000 is our Frac 4, which will be coming on-stream here late in the third quarter. And so that will relieve some pressure on the system that we're currently seeing because of that incident.

Theresa Chen
Analyst, Barclays Capital, Inc.

Q

Thank you.

Operator: Matthew Blair from Tudor, Pickering, Holt. Please go ahead. Your line is open.

Matthew Blair
Analyst, Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Hey. Good morning. Mark, as you look at the wide range of businesses that are under the PSX umbrella, are there any that stand out as perhaps not a long-term fit?

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Yeah. I think as we look at the businesses we're in, there's good integration across these businesses even as we add the Emerging Energy opportunities.

If you think about needle coke going into batteries, you think about our ability to produce and market and capture the full value chain around things like renewable diesel and sustainable aviation fuel. The Midstream assets that are integrated, in many respects, into CPChem and our ability to see through there, I think that, that – we're pretty comfortable with the integration opportunities there.

There's always individual assets that we look at, that may be able to create more value for someone else and we take a critical view at that consistently on our portfolio, if there's opportunities to do things around individual assets. We're always in optimization mode. But I think at a macro level, I think we like the businesses that we're in.

Jeff Dietert A
Vice President-Investor Relations, Phillips 66

And I think the work done at Rodeo and converting it to a renewable diesel facility and the conversion of Alliance to a terminal are examples of our searching for better opportunities for some of the existing assets.

Matthew Blair Q
Analyst, Tudor, Pickering, Holt & Co. Securities, Inc.

Got it. And then maybe sticking on Rodeo, you mentioned RD is a big part of your new energy growth strategy. I think that the capacity there is about 120 million gallons currently. Could you comment on the performance in the quarter from RD? What kind of utilization are you running at? And was that cash positive in the quarter?

Brian Mandell A
Executive Vice President-Marketing and Commercial, Phillips 66

Unit 250.

Richard G. Harbison A
Senior Vice President, Refining, Phillips 66

Unit 250, the unit that we have running now, yes.

Brian Mandell A
Executive Vice President-Marketing and Commercial, Phillips 66

Yes.

Richard G. Harbison A
Senior Vice President, Refining, Phillips 66

This is Rich, Matthew, and then I'll turn it over to Brian to add maybe some marketing color to it. But from an operating standpoint and utilization of what we call our Unit 250 that is currently producing renewable diesel, it's performing, I'd say, actually above expectations at this point in time. It's performing quite well. And the team out there that's running the unit has learned a lot, while they're running it, but they've also been able to extend our anticipated run lengths. And so all in all, the unit is performing above expectations, I would say, at this time. On the market side, Brian?

Brian Mandell
Executive Vice President-Marketing and Commercial, Phillips 66

A

I would say on the marketing side, we've been running more low CI material through Unit 250, which has been helping us. If you take a look at the heating oil spread, it's the slowest in the past year and a half, in large part because heating oil has risen much quicker than the feedstock into the plant. That's a benefit to us. And the RINs are very highly priced as well. So in terms of margin for Unit 250, it's very, very strong right now, and we expect that to continue for some time.

Matthew Blair
Analyst, Tudor, Pickering, Holt & Co. Securities, Inc.

Q

Great, thank you.

Brian Mandell
Executive Vice President-Marketing and Commercial, Phillips 66

A

Thanks, Matthew.

Operator: John Royall from JPMorgan, please go ahead. Your line is open.

John M. Royall
Analyst, JPMorgan Securities LLC

Q

Thanks for taking my question. So sticking with RD, can you speak to the potential extension of the BTC that's been in the news this week and how you think about returns on that project ex the BTC or with the BTC? And then any thoughts on LCFS price going forward, which has been on the weaker side recently but maybe some catalysts around the scoping process and the Canada program starting next year?

Brian Mandell
Executive Vice President-Marketing and Commercial, Phillips 66

A

I'll start with BTCs, and then Rich can take LCFS. But I would say that we premised the project, Rodeo Renewed, without the BTC. So that's an add-on to our economics. All the credits move together, so we wouldn't expect to see the full dollar, but we'd expect to see some value of that in the economics going forward.

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

John, it's Rich. As you alluded to there, the CARB, the California Air Resources Board state agency that's responsible for managing the LCFS program, has been talking about the LCFS program and the scoping plan development in recent conversations in the Sacramento area.

Just the conversation itself seems to have stabilized the LCFS credits over the last several weeks, and that seems to be a good signal. However, we're still not clear as to where this whole discussion is going. There has been some talk about changing the required obligation side, which will likely result in increased credit demand.

But more specifically, CARB has been discussing or proposed to discuss some changes to the CI reduction, carbon intensity reduction, that was originally targeted in 2030 as a 20% reduction. But now CARB's considering increasing that reduction to 25% to 30% by 2030. But this is all in conversation at this time. So let me emphasize that there's no certain path forward at this point.

However, we do think the Rodeo Renewed project still is quite attractive. And that project is premised on lower carbon intensity feedstocks as Brian mentioned there. And with the installation of the pretreatment unit, it still puts us in quite a competitive position at the facility.

John M. Royall
Analyst, JPMorgan Securities LLC

Q

That's really helpful. Thank you. And then the next one is back to Refining. Can you talk about the turnarounds coming in at the lower end of full-year guidance, if I heard that correctly? Was there any deferral there? Were you able to execute on any of your turnarounds at lower than expected costs? I'm just looking for some color there. And then maybe – I'm not sure if you're going to answer this, but any early look into the kind of year you might expect in 2023 relative to this year, where presumably, I would think you have some catch-up?

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

So this is Rich again. One of the things I'll mention, I'm quite honored to follow behind some of our previous leaders who instituted some programs here that we're now really taking advantage of. And one of those programs has been to improve our predictability of our turnaround execution. And those are really now starting to take shape. And we've been able to do that by improving our planning processes, execution, onboarding, all the fundamentals of executing a turnaround. And that's paying dividends for us now. And so that's the primary reason that we're working towards the lower end of our guidance on the annual spend is really our execution performance has been much better than we anticipated actually for that part.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

I think as far as this year, you're right, this year has been a catch-up year. We caught up on a lot of turnaround activity that was deferred out of the heavy COVID season because it was too risky. And we were able to save some cash outlays during volatile times. So I think you'll see the turnaround activity much lower and more typical year in 2023.

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

So the guidance isn't driven by deferrals of turnarounds as we've been executing those turnarounds.

John M. Royall
Analyst, JPMorgan Securities LLC

Q

Thank you.

Operator: Paul Cheng from Scotiabank, please go ahead. Your line is open.

Paul Y. Cheng
Analyst, Scotiabank GBM

Q

Hey, guys. Good morning.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Good morning, Paul.

Paul Y. Cheng
Analyst, Scotiabank GBM

Q

First, I want to also welcome and congratulate Mark to your first conference call as the CEO.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Thank you, Paul.

Paul Y. Cheng
Analyst, Scotiabank GBM

Q

Two questions. I think the first one is for Rich and the second one is for Mark. For Rich, yes, the market conditions remain very robust. By the time come next year, is there an option that you can postpone the shutdown of Rodeo or that you do need to shut it down because otherwise that you have to do a major maintenance or other reasons behind? If you can, just give us some idea on that. Is there any flexibility?

And the second question is for Mark. Mark, I think you touched on that. I think if we look back in last decade, the strategy for the company is quite clear. There's more Midstream, more Chemical, and less Refining. And at one point early on in the decade, I think even maybe in the long-term future, Refining don't need to be part of the portfolio. And as you take on the seat, what is the new look from you on the longer term, given that Midstream seems like it's already over invest. If you can, say, comment on those things, that would be great. Thank you.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

Sure, I'll let Rich take his up and then I'll follow on.

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

Okay, yes. Thanks for the question, Paul. Early in the second quarter, we received the land use permit from Contra Costa County to execute the Rodeo Renewed project. That included also a certified environmental impact report. That has subsequently initiated pre-construction activities. And we're on a path to significantly reduce the on-site criteria pollutants and support California's objectives of producing lower life cycle carbon intensive transportation fuels, while we continue to support family wage jobs there.

So, I think we're on a path to execute Rodeo Renewed. I don't see that changing at this point in time. Rodeo Renewed is a very capital-efficient project, as Mark mentioned earlier. It's roughly $1 a gallon investment versus other projects that have announced that are much higher in the $2 to $3-plus range. So we see Rodeo Renewed project remaining on track for start-up in Q1 of 2024.

Mark E. Lashier
President, Chief Executive Officer & Director, Phillips 66

A

And we like the economics of Rodeo Renewed. We've talked earlier in the call about the strength in the distillate market and the diesel market. And so those economics look strong.

Richard G. Harbison
Senior Vice President, Refining, Phillips 66

A

Yes. This project supports that.

Mark E. Lashier

President, Chief Executive Officer & Director, Phillips 66

A

Yes. As far as the portfolio and investments, I think that we always plan and have a strategy around investing where we can create the most value. I don't think we're talking about ever exiting Refining. I think that we see a long-term future in Refining, but we've got to make sure that we've got the right Refining assets to deliver what the market needs in the right locations. And I think that we've done a nice job of selectively investing in retail joint ventures that have helped capture the kinds of opportunities that you saw in the second quarter.

Midstream certainly as the Permian, West Texas basins came on strong, there were opportunities to put Midstream assets into capitalize on that as the growth in production there slowed down, as consolidation occurred in the upstream players, that changes that landscape. But we certainly continue to look for the right opportunities to create value around our Midstream assets, whether it's participating in consolidation or finding some pieces here or there we can invest in that's different. There's continued strong fundamentals, long-term fundamentals in petrochemicals that we want to participate in, the above GDP growth. We'll do that primarily through CPChem, but if we see opportunities where we can produce chemicals out of some of our existing Refining assets, we'll take a good look at that.

And then again, I mentioned in the opening comments that if we can find very targeted high-return, quick payout projects in Refining to improve our yield, to improve our utilization, to enhance our ability to capture what the market has to offer us, we'll make those in a very disciplined way as well. So I think that it's – the overarching strategy is driven by disciplined capital investments, finding the right way to capture value for the markets that are available to us.

And then we'll be building out our Emerging Energy business, too. And we're not going to invest, though, in Emerging Energy opportunities just to fly an Emerging Energy flag. It's going to be there to create value and capture value. So that's where we're headed.

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

Jeff Dietert

Vice President-Investor Relations, Phillips 66

Thanks. We greatly appreciate your time and interest in Phillips 66. If you have any questions following today's call, please contact Shannon or me. Thank you.

Operator: Thank you. Ladies and gentlemen, this concludes today's conference. You may now disconnect.