TRANSCRIPT
2Q 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 Second 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 afternoon, and welcome to the Phillips 66 Second 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 afternoon everyone, and thank you for joining us today. In the second quarter, we had adjusted earnings of $329 million. We generated operating cash flow of $1.7 billion. Excluding working capital, operating cash flow was $910 million. With the benefit of our diversified portfolio, we generated cash flow in excess of capital spending and dividends during the quarter.

We returned $394 million to shareholders through dividends in the quarter. Since we formed as a company, we've returned over $28 billion to shareholders. A secure, competitive dividend will continue to be a top priority for our company, and we anticipate a return to dividend growth as cash flow recovers. We're committed to disciplined capital allocation, focusing on debt repayment in the near term to support a conservative balance sheet and maintain our strong investment-grade credit ratings.

In July, the Phillips 66 Board of Directors appointed Denise Cade and Doug Terreson to serve as independent directors. We continue to work on board refreshment, recognizing the value of diversity in terms of gender, age, race, ethnicity, tenure, professional experiences and perspectives.

We'd like to highlight our recent 2021 sustainability report that can be accessed on our website. We think it's one of our best ones yet. Our commitment to sustainability is based on operating excellence, environmental stewardship, social responsibility and financial performance, led by strong corporate governance.

We expanded our commitment to environmental responsibility, setting a goal for all of our refineries to achieve top third energy efficiency by 2030. We modified our compensation program to add additional environmental goals. As previously communicated, we will establish meaningful and achievable greenhouse gas emission reduction targets later this year.

So with that, I'll turn the call over to Mark to provide some additional comments.

Mark Lashier:

Thanks, Greg. Good afternoon and thanks to everyone on the call for joining us today. Continued improved demand across Chevron Phillips Chemical Company's LLC (CPChem) product lines and resilient operating recovery from the first-quarter winter storms contributed to record quarterly earnings in our chemical segment.

Marketing & Specialties reported strong results as demand increased in many of our key domestic regions. Our Midstream segment recovered well from the first-quarter winter storms to reports solid results. Headwinds continued in our Refining segment, as RIN-adjusted refined product cracks only improved modestly, and historically low market capture contributed to continued losses.

As more people across the globe are vaccinated, we expect continued economic recovery and further improvement in global refined product demand. In addition, permanent refinery closure announcements have increased to over 3.7 million barrels per day globally, with additional closure announcements expected.

In Midstream, Phillips 66 Partners continues construction of the CTG Pipeline. The project is backed by long-term commitments and is expected to be operational in the fourth quarter of this year.

At the Sweeny Hub, we recently resumed construction of Frac 4, which will add 150,000 barrels per day of capacity. Upon completion, which is expected in the fourth quarter of 2022, the total Sweeny Hub fractionation capacity will increase to 550,000 barrels per day. The fracs are all supported by long-term commitments.

CPChem continues to develop two world-scale petrochemical facilities on the U.S. Gulf Coast and in Ras Laffan, Qatar. We expect a final investment decision for the U.S. Gulf Coast project next year. The Ras Laffan petrochemical project is progressing with front-end engineering and design as planned. Both projects are in partnership with Qatar Petroleum.

In addition, CPChem began construction of its second world-scale unit to produce 1-hexene, utilizing CPChem's proprietary technology. 1-hexene is used for high-performance polyethylene manufacturing, and it's common in a variety of everyday products, including packaging for food, consumer products and pharmaceuticals.

The unit, located in Old Ocean, Texas, will have a capacity of 266,000 metric tonnes per year and is expected to startup in 2023. In May, CPChem was recognized by the plastic industry association for being among the top 2021 industry innovators in sustainability. The award recognizes CPChem's launch of Marlex Anew Circular Polyethylene, which uses advanced recycling technology to convert plastic waste into high-quality raw materials.

We continue to advance our Rodeo Renewed project at the San Francisco Refinery. In July, we reached full production rates of 8,000 barrels per day of renewable diesel from the hydrotreater conversion. Subject to permitting and approvals, full conversion of the facility is expected in early 2024. Upon completion, Rodeo will have over 50,000 barrels per day of renewable fuel production capacity. The conversion will reduce emissions from the facility and produce lower-carbon transportation fuels. Rodeo, combined with our

portfolio of other renewable fuels projects, has the potential to supply 1 billion gallons of renewable fuels per year.

In Marketing, we're converting 600 branded retail sites in California to sell renewable diesel produced by the Rodeo facility. In Switzerland, our Coop retail joint venture continues to add hydrogen fueling stations. Through our joint venture, we're exploring hydrogen as a fuel option for heavy-duty vehicles to support European low- carbon goals and growing demand for sustainable fuels. We're moving forward and preparing for the future while maintaining our focus on safe, reliable operations and attractive shareholder returns.

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

Kevin Mitchell:

Thank you, Mark. Hello everyone. Starting with an overview on Slide 4, we summarize our second-quarter results. We reported earnings of $296 million. Excluding special items, we had adjusted earnings of $329 million, or $0.74 per share. We generated operating cash flow of $1.7 billion, including a working capital benefit of $833 million and cash distributions from equity affiliates of $612 million. Capital spending for the quarter was $380 million, including $179 million for growth projects. We paid $394 million in dividends.

Moving to slide 5, this slide shows the change in adjusted results from the first quarter to the second quarter, an increase of $838 million. Pre-tax income improved across all segments, with the largest contribution from Chemicals. Our adjusted effective income tax rate was 19%.

Slide 6 shows our Midstream results. Second-quarter adjusted pre-tax income was $316 million, an increase of $40 million from the previous quarter. Transportation contributed adjusted pre-tax income of $224 million, up $18 million from the previous quarter. The increase was due to improved volumes from higher refinery utilization, partially offset by higher costs due to the timing of maintenance and asset integrity work.

NGL and Other adjusted pre-tax income was $83 million. The $47 million increase from the prior quarter was mainly due to lower operating costs and higher volumes, reflecting recovery from the winter storms.

The Sweeny fractionation complex averaged 380,000 barrels per day, and the Freeport LPG Export facility loaded a record 42 cargoes in the second quarter. DCP Midstream adjusted pre-tax income of $9 million was down $25 million from the previous quarter, mainly due to lower mark-to-market hedging results from higher natural gas and NGL prices.

Turning to Chemicals on slide 7, second-quarter adjusted pre-tax income was $657 million, up $473 million from the first quarter. This is the highest quarterly earnings for Chemicals since the joint venture was formed in 2000.

Olefins & Polyolefins (O&P) adjusted pre-tax income was $593 million. The $419 million increase from the previous quarter was driven by strong demand, tight supplies, and recovery from the winter storms that contributed to higher margins and lower utility costs. The industry chain margin increased over $0.17 per pound to a record $0.62 per pound.

Global O&P utilization was 102% for the quarter. Adjusted pre-tax income for SA&S increased $55 million. The increase primarily reflects improved margins due to tight industry supplies following the winter storms

and lower turnaround costs. During the second quarter, we received $322 million in cash distributions from CPChem.

Turning to Refining on slide 8. Refining second-quarter adjusted pre-tax loss was $706 million, an improvement of $320 million from the first quarter. The improvement was driven by lower utility and turnaround costs and higher volumes. This was partially offset by lower realized margins. Improved market crack spreads were more than offset by higher RIN costs, lower electricity sales in the Texas market, decreased secondary product margins, lower clean product differentials and inventory impacts.

Pre-tax turnaround costs were $118 million, down from $192 million in the prior quarter. Crude utilization was 88% compared with 74% last quarter. The second-quarter clean product yield was 82%.

Slide 9 covers market capture. The 3:2:1 market crack for the second quarter was $17.76 per barrel compared to $13.23 per barrel in the first quarter. Realized margin was $3.92 per barrel and resulted in an overall market capture of 22%. Market capture in the previous quarter was 33%. Market capture is impacted by the configuration of our refineries. Our refineries are more heavily weighted toward distillate production than the market indicator. During the quarter, the gasoline crack improved $5.68 per barrel, while the distillate crack increased $2.20 per barrel.

Losses from secondary products of $2.38 per barrel were $1.09 per barrel higher than the previous quarter as crude prices strengthened. Feedstock costs improved $0.36 per barrel compared with the prior quarter. The Other category reduced realized margins by $7.84 per barrel. This category includes RINs, freight costs, clean product realizations and inventory impacts.

Moving to Marketing & Specialties on slide 10. Adjusted second-quarter pre-tax income was $479 million compared with $290 million in the prior quarter. Marketing & Other increased $181 million due to higher domestic margins and volumes, reflecting strong demand in key markets. Refined product exports in the second quarter were 216,000 barrels per day. Specialties generated second-quarter adjusted pre-tax income of $87 million, up from $79 million in the prior quarter.

Slide 11 shows the change in cash for the quarter. We started the quarter with a $1.4 billion cash balance. Cash from operations was $1.7 million. This included a working capital benefit of $833 million. In June, we received a $1.1 billion U.S. federal income tax refund, which is reflected in working capital. Cash from operations excluding working capital was $910 million, which more than covered $380 million of capital spend and $394 million for the dividend. The Other category includes a $90 million loan to our WRB joint venture. Our ending cash balance was $2.2 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, crude utilization will be adjusted according to market conditions. In July, utilization averaged around 90%. We expect third-quarter pre-tax turnaround expenses to be between $120 million and $150 million. We anticipate third-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:

Good morning team. Thanks for taking the question. The first one is on Chemicals and, Mark, this might be for you. Kevin indicated that the indicator was $0.62, which is very robust and above midcycle in Q2. How do you see it playing out in July and August so far? And, just any thoughts on what the midcycle number has been? I think you guys have been in the $0.25 camp if I remember. Has that view changed in light of reaching margins strength?

Mark Lashier:

Yes, thanks, Neil. It's a great question. We're still consistent on our midcycle margin projection. And of course, we're well above that today and as we look out into the third quarter, we're seeing the strength continue in the third quarter. We've got cost increases on the table that are being negotiated as we speak. But even if things went forward just as they are today, we're still at record margins, and we think that can carry into the third quarter. There's a lot of strength in the marketplace, particularly in North America and in Europe. Asia is still kind of lagging but starting to perk up a little bit.

So the real story is the fundamental economic resurgence in the U.S., in North America and Europe. And we believe that there's some upside that will offset some headwinds out in the future, as the rest of the global economy kicks in.

Now we're at record margins. Nobody believes those are sustainable for the long term. However, I think we can go from something at the record level to something that's still pretty robust. We see a seasonal downturn typically in the fourth quarter, but we've also seen conditions where we can carry through when there's strong enough marketing momentum, and there may be those kinds of conditions now. We're particularly focused on high-density polyethylene, and that's still pretty tight in the marketplace.

The inventories have not recovered to where CPChem would be comfortable operating, and it's unusual to be there this time of year with hurricane season. We typically want to be a little higher in inventories going into hurricane season. So there's a number of factors that could lead to sustaining this momentum into the third quarter and beyond into the fourth quarter. And then we see the world economy kicking in about the same time, additional capacity is coming on, say the first half of next year. So there are some good fundamentals out there, and I think it's still got some legs based on the demand that will come to bear as the world economy fully recovers from COVID-19.

Jeff Dietert:

Neil, we talk about midcycle being the 2012 to 2019 average, and if you look at the IHS polyethylene full chain margin, it's averaged about $0.30 per pound.

Neil Mehta:

Okay, $0.30 per pound. Okay, that's all great. And then the follow-up, Greg and Jeff, this is for you, just thoughts on the refining side of the equation. In the refining system, if you told me the refining system was running at these types of levels, I would have thought that Phillips 66 would have been making a pre-tax profit in the refining system. And so is the U.S. refining system running too hard? And how are you guys thinking about your own utilization as you get into the fall?

Robert Herman:

Yes, it's Bob. I'll take that question. When you look back over the last quarter, I think there were plenty of market signals there for us to run at the utilization rates we're at. There are a lot of moving parts. In particular, the cost of RINs that just continued to increase throughout the quarter, right, and we take a pretty good hit in Refining for the full cost of those RINs. We would have all expected maybe on a global basis, Europe and Asia demand ticked back a little better than it did. I think the margins, the RIN-adjusted margins that we saw in the second quarter, really across our system are very representative of a global market. So until we start seeing recovery, particularly in Europe, because we seem to see product flowing out of Europe into North America and South America, we won't really see RINs get back to where we would like to see them.

I think the second piece for us, in particular, is more geared toward heavy crudes making diesel. Certainly, for the second quarter, it was a gasoline-driven market without much differential on heavy crudes, and we've seen those widen out here now in July to a much more respectable level. So, we think it's headed in the right direction. But I think all that added up to being challenged in the second quarter to turn a 90% type utilization number into a profit.

Greg Garland:

Brian, do you want to comment on what we're seeing today in the market?

Brian Mandell:

In terms of the heavy diffs and sour diffs, we've seen them start to expand. LLS to Mars is $2 wider since the beginning of the year, WTI to Maya is $3 wider since the beginning of the year. So I think we have some tailwinds that are going to help us in the third quarter. We expect distillate cracks to perform as we get toward wintertime. So, all in all, I think we've also seen actually markets overseas come back. We have Marketing in Europe, And we've seen in Europe, Germany where we market, 90% to 95% of demand, Austria where we market,100% of demand, so we've seen those markets come back as well. So,as Bob said, if the overseas market starts to come back, that will help the U.S. cracks, and we should see some profitability in Q3.

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?

Jeff Dietert:

One thing I might add is if you look at the IEA, EIA, OPEC projections, we were shy of 95 million barrels a day in 2Q, projected to get to 99.5 million barrels a day by the end of the year. So, expectations for demand to continue to improve in the back half of the year.

Neil Mehta:

Great, guys. Thank you.

Operator:

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

Roger Read:

Good morning or afternoon, as the case may be. Jumping back to Refining here. I guess one of the questions is it'sobvious that things should improve, but is there anything internally that Phillips 66 has done or plans to do to help out on the margin front? Just thinking of any additional changes within your own system or anything else that might be part of the Phillips 66 AdvantEdge66 (AE66) program that was laid out almost two years ago now?

Robert Herman:

Yes. Roger, I think there are a couple of answers to that question, one internally, right. We expected top operating conditions for a good part of this year. Recovery has been slower than we expected. But we went into this year trying to reduce some of our heavy maintenance expenses and adjusting turnarounds and all that. And so the guidance Kevin just gave, right, for the third quarter is fairly light for us. So I think that helps heading into the third-quarter profitability. You can translate that as we're available to run. So, if the cracks are there, we're going to be able to run pretty hard in the third quarter and make money.

Around the AdvantEdge66 program that we laid out, right, so a lot of that is built around margin enhancement and margin improvement. So, we ran pretty well in the second quarter, and we're using all those tools that are in our toolkit. The value chain optimization activities that went on in the second quarter were pretty robust. We did a lot of things that we hadn't done before or needed to do before, such as we ran a lot of resid down into our Sweeny Refinery, where typically we'd be running Maya or some of the heavy Canadians. The profitability really wasn't there and so optimizing around high-sulfur resids into our system is just one example of where we're running the circuit.

So we're pretty happy with the results we're seeing on the operating front. A lot of our initiatives in Refining are around being able to operate well, operate better, operate safer with a smaller environmental footprint, and we're seeing value come out of all of those initiatives. They don't necessarily translate directly to the bottom line where you can see them, but over time they're paying dividends.

Greg Garland:

Roger, when I think about Q2 and maybe even Q1, we've had quite a bit of planned and unplanned FCC downtime this year. So if you look at our yields relative to historical yields, we're probably down 2%. And so we're just simply going to run better in the third quarter and fourth quarter. I think Bob's got things tuned up that we're ready to do that. So, I think that's one of the things that we're focusing on right now also.

Roger Read:

Okay, great. Thanks. And then, one thing that was definitely nice this quarter, generating enough cash flow to cover all the outflows. I don't know, Kevin, if this question is for you. But as you look at budgeting for the back half of the year, things are as they are today, I think that we've pretty much turned the corner on the COVID-19 world, and Phillips 66 will be in a position to improve the balance sheet, start taking some of the debt down as we go through the next say two to four quarters.

Kevin Mitchell:

Yes, Roger, certainly would expect to be able to do that. I mean obviously we're not back at midcycle cash generation yet, which is really going to be our sort of key marker in terms of truly being able to get the balance sheet back to where we need it to be. But it's certainly a nice improvement from where we've been.

And with the cash balance, and if we continue to build that over the course of the year, we should be able to start making some inroads into that next year. And as you know, as we've talked about before, we have a lot of flexibility around debt reduction given the profile of the maturities that we have starting next year and some of the callable debt that we have in place. So, a lot of flexibility on that front.

Roger Read:

Great. Thank you.

Operator:

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

Doug Leggate:

Thank you. Good afternoon everybody. Gents, I wonder if I could ask you how, when you go through a cycle like this, in obviously a downturn, one in margins that you are stress testing all of the assets in the portfolio. So, I guess as kind of a follow-up to Roger's question, do you see any weak links in the portfolio today that you think might be revisited in terms of portfolio structure, specifically on the Refining side? I'm obviously thinking specifically about the Atlantic Basin.

Robert Herman:

Yes, Doug. I guess I would say that we spend a fair amount of time every year stress testing and looking at every one of our assets and where do we think the future of that asset lies. And in a bigger picture context too, not just the Refining asset but the rest of our value chain around it, right, how much marketing are we supplying in the area. We've got Midstream assets. Commercial is trading around many of our assets, particularly on the coast. So, we look at a much more holistic picture.And quite frankly, we have a deck that we think is a long-term deck, considering what we think the future holds for liquid fuels, and we look at our assets in that context. So, they are assets at the end of the day. And so, we're always looking to upgrade or find more ways to make money on any given asset from year to year.

Doug Leggate:

We will watch with interest as that evolves. I guess my follow-up may be for Kevin, slide 9, you give a fairly clear description of how your realized margin has evolved this quarter. The $7.84 delta, can you maybe walk us through how much of that — maybe you can dig into a little more detail as to how much of that is truly transitory that we should expect to address? And I'll leave it there. Thanks.

Kevin Mitchell:

Yes, Doug, so the largest single element within that $7.84 Other is the RIN costs that, as Bob referenced earlier, is that expense borne by Refining. And so, it is half or slightly more than half of the total within that Other. Most of the other items in there are – well, RIN is always in there. RINs costs were particularly high during the quarter.

Product differentials, which is the difference between the market indicator and actual product realizations, that one can move around and go both directions on us. During the quarter, those differentials we were not getting, seeing the value for some of those premium products that often can be a benefit to us in the quarter. So, that's one that can move around and come back the other direction. And then the other

component that's also in there, again it can go both directions, is inventory impacts. And so, inventory was a hurt to earnings in Refining in this particular quarter, but that can move in both directions.

Doug Leggate:

So just to be clear, the configuration, so your different slate and product mix, that's not in configuration, that's in Other? Or how should we think about that?

Kevin Mitchell:

No. The configuration reflects the 3:2:1. So, two-thirds gasoline, one-third distillate in the market indicator versus what we actually produce by way of gasoline and distillate. In Other, you've got the actual pricing for those products, including whether it's premium gasoline and other premium products that can often be an uplift relative to the standard market indicator. But in this period, they were not.

Doug Leggate:

Great stuff. Appreciate the information. Thank you.

Operator:

Your next question comes from Phil Gresh with JPMorgan.

Phil Gresh:

Yes, good afternoon. Greg, in the past, you always have referenced normalized earnings potential across the various areas of the portfolio. And I'm curious how you think about Refining's normalized EBITDA potential now that we've kind of gone through this COVID-19 cycle. Is there anything that, having gone through this, has changed your view? I think there's a $4 billion EBITDA number that you've thought about in the past.

Greg Garland:

No, at the Analyst Day in 2019, we laid out a $4 billion EBITDA number. And that at the time was a $12 to $19 average EBITDA for our Refining business. I don't think we're ready to sound a retreat yet on midcycle on Refining. So it's been, if you go back, all the way back to the first quarter of 2020, that's the last time we actually made money as a company. So, it's been a long haul as we've come through this. There's no question.

There's been a lot of stress put on a lot of companies in our industry. But I think we're constructive, particularly as we come in the back half of the year around demand. This has been a story of vaccinations, efficiency, lockdowns, and people trying to get back to some semblance of normal, and that all translates strictly into the demand that we see for our products. And there's no question; I think the U.S. probably led in terms of demand recovery through this cycle. And so we've seen the impacts of Europe coming to the U.S. We've seen impacts of not being able to export as much as we'd like to South America in places.

And so, I think as the world returns to normal, we've got a good shot at getting back to something that looks more like the midcycle. I think we said on the last call, we really need to see that 3:2:1 crack on a RIN-adjusted basis to get back to about $12. And then I think we'll see the appropriate kind of market captures around that to be able to generate something around $4 billion. Jeff, I don't know if you've got — you want to add anything on that?

Jeff Dietert:

Yes, I think you guys have hit on the demand side of the equation. We are seeing Refining rationalization of 3.7 million barrels a day of announced closures, 800,000 a day of temporary outages that could become more permanent. And we're up to about 1.7 million barrels a day of capacity that's been announced as considering either terminals or other types of service or potential shutdown. So that rationalization is a big piece of it as well. And I think we're expecting more closures to be announced.

Phil Gresh:

Okay. In the press release, there is a mention of returning to dividend growth as cash flow recovers. So I was hoping maybe you can lay out the priorities in terms of where you want that balance sheet leverage to get to before you would reconsider dividend growth. And, Kevin, just quickly, I think you said $1.1 billion for the tax refund in the second quarter. Is it still $1.5 billion for the year?

Kevin Mitchell:

So in terms of the tax refund, you're right that it's about $1.5 billion total. We received $1.1 billion. There's another $350 million or thereabouts, but we don't expect the remainder to be a 2021 cash item. That will roll into next year. So, for a variety of reasons, that's not going to be cash for this year, although it still will realize itself over time for us on that.

And then in terms of dividend growth, I think we go back to the earlier comments around as cash generation recovers to something around about midcycle, and we're in a position to pay down debt. We're making progress on paying down debt. We've got sort of a clear line of sight to our ability to continue to do that and get the balance sheet back to where we want it to be, then we should feel comfortable on some of the other capital allocation priorities and increasing the dividend is one of those.

So, I think it's a little bit of a long-winded way of saying we don't need to get to all the way we want to get to on the balance sheet before we make a decision on the dividend. We just need to be very comfortable that the structure is there, the cash generation is there. We're making the progress we need to make and, therefore; we'll be able to signal that in terms of our confidence to shareholders with the dividend.

Greg Garland:

Yes. I think it's important. I think overriding, we do want to protect the BBB+, A3 rating. So we think a lot about that. And I think our milepost is starting to approach midcycle earnings for our company. As you know, $6 billion to $7 billion of cash flow at midcycle, that gives us plenty of cover to do the things we need to do.

I think we've said in previous calls, we expect CapEx for the next couple of years to be $2 billion or less. And so you think in the context of $6 billion to $7 billion of cash flow, a total capital program of $2 billion and $1.6 billion dividend. Then I think we'll have plenty of room to do the things we want to do around bringing the balance sheet into order, thinking about capital return to our shareholders through dividend increases and share repurchases.

Operator:

Your next question comes from Paul Cheng with Scotiabank.

Paul Cheng:

Hi, guys. Good afternoon. Two questions. Greg, I think if I look at your NGL business, this quarter your EBITDA was around $135 million. In 2019 the average quarterly EBITDA was about $170 million. But we have the fractionator 2 and fractionator 3 come onstream and actually at the full operation, which probably should at least contribute $30 million, $40 million a quarter in the EBITDA, if not more. So trying to reconcile that, did the market conditions really change that much? Or will that get that much worse because NGL price is actually very good in the second quarter? So maybe someone can help us on that.

The second question will be just a real quick one. On the renewable, the full plant conversion, I just want to see if there's a permit status that you can provide? And also that the last couple years you guys have been trying to rebrand the work process and go for digitization. And so I just wanted to see if you can give an update on where we are on that? Is that pretty much done with what you guys aim from couple of years ago? I think at the time that the cost-savings target was pretty high but with the pandemic, I mean everything got messed up. So it's very difficult to reconcile. So maybe you can give us some updates.

Tim Roberts:

Paul this is Tim Roberts. So, on your NGL question. The first thing I would say is in 2019, I wish we were back in that macro. That was a good time with regard to the overall supply/demand fundamentals. Global demand was where you wanted it to be on really all of our Midstream products, whether it was crude, products or NGLs. So fundamentally, there are big changes in the market.

But when you look specifically at 2021, let me just highlight a couple of things for you there that have reared their head. The biggest one that's had the biggest impact is Winter Storm Uri. When you look at Uri, it impacted our fracs significantly down there. And mainly not from the standpoint of damaging the units or any issues there. Even though we did have some costs with the units, it was on utilities. Our utility bill was significant. So from that standpoint, that's going to be hard to claw back for the rest of this year.

So on a positive note, I'd just tell you structurally, we like the NGL business. Demand has been very robust to support chemicals growth both locally and globally. NGL production is ramping up. We still see about 1 million barrels in rejection at this point in time. But overall, demand is really good in that space. Our LPG exports have been in a record clip. So overall the fundamentals feel good that it was a big cost hit, as well as lost production hit that we had initially in 1Q, which really on a year-to-date basis stays with us.

The last thing I'd just cover in Q2, the overall structure in NGLs has jumped up significantly as you probably are well aware, propanes, butanes and ethane. We're at about $0.86, $0.87 on a gallon basis for NGL on a composite. In 2019, it was $0.37. So it's gone up. And with that, we've seen an impact on some mark to market we have in some of our inventory. So that's there. That usually turns into a timing issue. But nonetheless, that shows up in the results in 2Q.

Paul Cheng:

How big is that the impact on the mark to market in the second quarter?

Tim Roberts:

I'm going to guesstimate right now. I don't have the number in front of me. It was around $10 million or $11 million.

Robert Herman:

Paul, it's Bob. I think your second question was around the permitting status at Rodeo Renewed and the conversion out there of the refinery to run in renewable fuel. So, we continue to develop the environmental impact statement with Contra Costa County. I would characterize that it has gone about as well as it could, better than we expected. We're essentially done writing the permit. It's in review right now internally with the county, and we would expect them to probably sometime this month release the permit to begin the public comment period.

So that would be pretty much right on our timeline, maybe a little bit ahead. And so far, it's been a good, cooperative process with the regulators and their permit writers. So we're encouraged and pretty happy where we are. We continue the outreach with all the other stakeholders in Contra Costa County and Northern California to make sure everybody understands what that project is going to do for the Bay Area and for California in general. So, so far, so good.

Yes, the third piece, I think the question was around the AE66 and cost reductions. And you're right, in a year like 2020, it's hard to see it. But I would say we've been able to deliver within bounds of the environment on both sides of the equation. So we've had good optimization opportunities around reduced utilization in our refineries, and our ability to get down as low as we did and to make debt go away and all those, I think were much easier because of some of the efforts we had.

The second piece I would say is at the height of COVID-19, when we had to social distance and we had to use alternative work approaches and everything, our early jump into digitalization allowed our people to get a lot more done without human contact and really was a dividend to us upfront in our ability to keep supporting the operators who were on the units, while minimizing contact with the outside world.

And the third piece is we were able to hold the line on costs quite well throughout last year. And, in fact, we saw cost reductions in many of our bigger cost items, caps and cams and those sorts of things that are a big piece of our operating budget. We applied some of the learnings that we got through AE66 to those. And I think we got sustainable longer-term price reductions there that will continue to pay out throughout this year. So, full steam ahead on all our initiatives there, particularly in Refining.

Greg Garland:

Paul, I might just come in and just say, I mean we're never done on the controllable cost side of our business. There's more work we've got to do in terms of continuing to address cost. That's what you do in a commodity business. When I look at the controllable costs through the first six months of this year relative to the first six months of last year, we're up about $300 million, almost all of that’s energy costs in Q1. And so if you adjust for the energy component, we're kind of holding the cost savings we were able to achieve last year. But that's not good enough. There's more work for us to do on the controllable costs side of it. So, hopefully you've got all those questions answered.

Jeff Dietert:

Thanks, Paul.

Operator:

Your next question comes from Theresa Chen with Barclays.

Theresa Chen:

Hi there. Thanks for taking my questions. I guess first, just on the topic of global refining capacity and closures going forward. I'm curious to hear about your outlook for the European market in general, given your exposure there. And, during the quarter, the macro data looked weak for a good portion. Now we're seeing some strengthening there and hearing, seeing news of operators starting units and calling back workers. Just curious to hear about how you see that evolving in the closures landscape.

Jeff Dietert:

Yes. So I think Europe has been one of the most challenged market in the first half of the year, lower margins and lower complexity. I think the demand has been slow to recover there. We are seeing some improvement, but it looks like one of the more challenging regions. I think we've seen continued weakness in Latin American in refining utilization, as well that could be a challenged area also. And I think there was an expectation for a stronger summer than what we've actually had, and as we come into the fall, that's typically where we see more closure announcement activity.

Brian Mandell:

I would say the weakness, and we pointed this out, the weakness in Europe has translated to weakness in the U.S. on our refinery margins. We've seen typically 100,000 barrels of diesel imports into the U.S. this year. We've seen 200,000 barrels of diesel imports into the U.S. from Europe.

We expect as Europe comes back from COVID-19 lockdown that those increased barrels will stop. We saw high imports of gasoline from Europe as well. We believe that will stop too as Europe comes back from lockdowns. We've seen it already taper off. So all those things when the refinery complex comes back in Europe and COVID-19 lockdowns decrease, we'll see the U.S. also strengthen.

Theresa Chen:

Got it. And then just on the crude side, can you talk to us about your medium- to long-term outlook for WCS differentials in light of Enbridge's line 3 replacement project coming online in fourth quarter, should that l narrow the differentials to the Mid-Con? And subsequently when we think about cap line reversal happening later on, can there be a situation where you see the St. James market being flooded with incremental heavy barrels, which could actually help your Gulf Coast facilities while the Mid-Con would be a little weaker with narrower, structurally narrow WCS spreads? And how do we see that thematic development playing out?

Brian Mandell:

So I would say on the WCS, we have seen differentials come off quite a bit. We got 4.5 million barrels that need to leave Canada currently. We have about 4.4 million barrels of pipeline, egress of another 100,000 barrels on rail. But we've seen, which is something a little different from what we've seen in the past couple years, is we've seen the WCS differential in the Gulf Coast weaken. It's weakened about $2.5 over the past couple of quarters. And when that weakens, so does the Hardisty WCS differential you have to have in order to get the barrels to the Gulf Coast.

And one of the reasons the Gulf Coast is weakening is because low exports means that you have to have a weaker differential on WCS to get that WCS exported out of the U.S. So, as you said Theresa, we have the Enbridge coming online in next quarter, quarter four, we would think that would firm up differentials a bit. But don't forget in the wintertime we add diluent to the crude and that also increases the volume of crude that

has to move. So our view, our forecast is that you'll see differentials somewhere between $12.5 and $13.5 off of WTI going forward.

Operator:

Your next question comes from Manav Gupta with Credit Suisse.

Manav Gupta:

Hi, guys. I wanted to focus on the Rodeo conversion. We are seeing two trends out there. One, there are guys who are not building a pretreat and their cost is varying between $1 to $1.50 a gallon. And then there are guys who are building the pretreat and their cost is varying between $3 to about $3.50 a gallon. You make five standard deviations from it. You are the only one who's building a pretreat, and your cost is $1 a gallon. So, help us understand what is special about this plan? I'm not trying to question. I'm sure you'll get there. But why is it so unique that you can pull this off and nobody else can?

Robert Herman:

It's Bob. I agree with you. We will get there. So, what really sets up Rodeo completely differently, one is the full plant conversion, so we have all the kit available. And we have two very high-pressure hydrocrackers that we can put into service. And to convert those units from where they are today to being able to run renewable diesel is actually a very low-cost part of the project. So, most of the cost of that project is in either the logistics piece and then the big chunk is the pretreaters themselves.

So, I think that's what allows us to be able to have a unique position of building a project that's going to be at an installed cost of about $1 a gallon, which you're right is lower than anybody else. But it is because if there was a refinery that was custom built to be able to be converted to renewable feedstocks, Rodeo is it since it's very unusual to have two hydrocrackers and excess hydrogen capacity on-site between our own hydrogen plant and that of our third-party supplier that is built at the site. So, we've got a perfect storm there. We're spending money to get all the logistics right, a little bit of metaling up in the hydrocrackers and in the pretreatment unit and we'll be ready to go.

Manav Gupta:

Perfect, sir. I have just one quick follow-up. I think the pandemic somewhat changed the nature of people as when it comes to the use of plastics and that could somewhere be permanent. I'm just trying to understand. You have these two crackers, which you kind of put on a back burner. You can bring them forward, FID them. I'm just trying to understand. Let's say you do decide that, from the point of FID, how long will it take to get the first one and the second one? So, if this change is permanent and the demand for plastics is in an up cycle, can capture a part of it?

Mark Lashier:

Well obviously, we agree that the fundamentals have improved dramatically since we initiated these projects. And as I noted earlier, the U.S. Gulf Coast we're looking at FID next year and the Qatar project is about a year behind that and you can target about four years from FID to startup. And we believe, though we don't try to market time, these investments that we do believe that window is a particularly good window to pursue something.

So we've got our foot forward on these. We are ready to move and we're working with contractors to make sure that we're getting the capital cost right. Clearly, the global markets are improving but there's still some disruption in the world economy. We'd like to see a little clearer path to a fully resolved economic recovery from COVID-19, get the delta variant and any other variants behind us, but we are leaning in and ready to move with FID on that project next year.

Operator:

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

Matthew Blair:

Hi, good morning. Thanks for taking my questions here. First is on chems. Could you share some color on the PE inventory picture? The industry data shows that PE inventories have really ballooned up to new highs, but your release talks about tight supplies. Lyondell and Dow also say the inventory is pretty tight. So, I was hoping you could just explain the disconnect there.

Mark Lashier:

Well one of the disconnects, Matthew, is looking at just the gross inventories versus the days of sales of inventories because demand has increased almost 6% in North America. And so that's important. And then you also have to parse it out by kind of polyethylene, because high density, linear low density, low density, all have different inventory levels and different applications.

And we're heavily exposed to high density, and high density is particularly tight supply now and uncomfortably tight. It's been building. CPChem ran at 102% of their capacity in the second quarter, so they really delivered from an operational excellence perspective. But much of that went into rebuilding those inventories.

So even though they had such a strong quarter, a lot of that production went into inventory and they're still not where they would comfortably be heading into a hurricane season. They like to be prepared for that. They don't plan to have a hurricane, but they're prepared if there are hurricanes that impact that. So I think that's where you're seeing the tightness. It's really from a day of sales perspective with the high growth in demand in North America, as well as where we are in the weather cycles in North America.

Matthew Blair:

Sounds good. And then, California LCFS status showed that combined RD and biodiesel blend rates in the state were about 35% in Q1. It seems like that number is only going to move higher going forward. But I was wondering, are you feeling a pinch on placing your diesel out of the Los Angeles Refinery and what are your long-term options here?

Tim Roberts:

No. Most of our diesel in the Los Angeles Refinery goes out of state, out of California. So that's a non-issue for us there, Matthew.

Operator:

Your next question comes from Jason Gabelman with Cowen.

Jason Gabelman:

Thanks for taking my questions. I wanted to ask two specific to the quarter on Refining earnings related to RINs. It seems like Marketing earnings increased a decent amount this quarter and refining is still kind of in the doldrums in part due to RINs. And I understand there's some accounting and value split between the RIN benefit in marketing versus the costs in Refining. So, can you just talk about maybe how RINs benefited Marketing this quarter and how much of your RIN exposure is being minimized by blending and pass-through to consumers?

And then, the second question just also on the quarter quickly, co-product realizations I know were a relatively larger than normal headwind. How is that looking 3Q quarter-to-date so far? Thanks.

Brian Mandell:

Jason, this is Brian. I'll start off on the RINs question. Our view is that the RINs are in the crack. It's a cost that refining pays and that the crack is passed on. The value of the crack is passed on to the consumer who pays for the RIN at the pump. So Marketing doesn't see any benefit from the RINs per se. There may be some leakage in that chain, but Marketing doesn't really see any benefit. Marketing did have a really strong quarter in Q2 and a large part of that was we had the right portfolio in the right places.

We saw demand jump up in March and then again in June. We have a strong presence in the Rockies and in the Mid-Con where there were less COVID-19 lockdowns and more movement. We added, as you know, retail in late 2019 and also in 2020 on the West Coast and that retail has done better than premised. We also added retail this year in the Mid-Con and Rockies and that retail is doing better than premised.

And finally I'd add that we've been reimaging the stores for the past three years. We're up to 85% of the stores reimaged, and we've seen a 2% to 3% jump in volumes and margins in those stores as well. So, we've done a lot of things to help our portfolios in the right spots. And so, I think that's where we saw the value in marketing in Q2.

Jeff Dietert:

I think on the secondary products within refining, they typically get squeezed in a rising oil price environment and improve in a declining oil price environment and we're kind of four quarters in a row of rising oil prices here. So, I think that's the biggest variable driving that secondary product margin.

Robert Herman:

Yes, I would agree 100% with Jeff. And usually, we get this time of year too, we start seeing a little help in the secondary products because some of the coke we make ends up in the asphalt market then this time of the year, right, as people are out fixing roads and bridges and all those things. And that's offset a little bit but we quit blending butane in the back half of the second quarter; it comes back again in September. So, there's a lot of moving parts in there. But I would think we're probably, this is kind of the maximum we would see for this type of oil price.

Operator:

And your next question comes from Ryan Todd with Piper Sandler.

Ryan Todd:

Hi, thanks. Maybe just a couple of quick questions on the renewable diesel business. Having ramped the Rodeo hydrotreater to the near-term target capacity of 8,000 barrels a day, I mean, can you speak to any learnings or takeaways that you have from getting to that kind of critical milestone and what you're seeing from kind of a margin or a profitability point of view?

And then maybe a follow-up. Can you talk about what it entails to convert your marketing locations to market renewable diesel, what the capital cost is associated with it? And how you envision kind of the marketing effort of RD to play out as the Rodeo conversion fully ramps up over the next few years?

Robert Herman:

This is Bob. I'll take the first question. So as we came out of turnaround and started up the Rodeo hydrotreater and renewable service, actually it came up and ran really well. We had almost a full quarter running at low rates. We still have project to get the rail infrastructure finished, so that we can supply 9,000 barrels a day to make the 8,000 barrels a day of renewable diesel.

So we're learning how the catalyst reacts and what the actual kinetics are around running bean oil. It's a little bit of a learning for the ultimate project of converting a refinery. And these are really — these projects really are two very separate things in that there was no real work to do to convert 250 to bean oil. It was a matter of changing the catalyst at a regular scheduled turnaround and then being able to run it. So it's helpful.

I think the bigger picture there is, it's very helpful to our commercial organization to learn how to source renewable feedstocks, the logistics of getting them there, some of the peculiar areas around transporting it. And those sorts of things all set us up to be a lot more nimble and ready for when we go from 8,000 barrels a day to 50,000 barrels a day with the renewable conversion. I think probably the best thing to come out of it is we did not see anything that made us stop and think about the project to convert the rest of the refinery that we needed to go back and think about our design. Pretty much operating as expected.

Brian Mandell:

And I would add to Bob, we got that plant up two and half months earlier than we thought. Nine thousand barrels into the plant, high conversion rate, just kind of a great asset so far. We've firmed up that over 50% of the feedstock for the plant going forward. We run soybean, but we've also run other vegetable oils there. So we have some experience going with other vegetable oils. We're looking at international feed as well. We started converting stores as you mentioned. It's low capital to convert the stores. We'll have all 600 stores converted by the end of the year and that will allow us to run volumes equal to three-fourths or more of the RND that we're producing currently.

Operator:

We have reached the end of today's call. You may now disconnect.