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PSX.N - Q3 2023 Phillips 66 Earnings Call

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OVERVIEW:

Company Summary

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CORPORATE PARTICIPANTS

Brian M. Mandell *Phillips 66 - EVP of Marketing & Commercial*

Jeffrey Alan Dietert *Phillips 66 - VP of IR*

Kevin J. Mitchell *Phillips 66 - Executive VP & CFO*

Mark E. Lashier *Phillips 66 - President, CEO & Director*

Richard G. Harbison *Phillips 66 - EVP of Refining*

Timothy D. Roberts *Phillips 66 - EVP of Midstream & Chemicals*

CONFERENCE CALL PARTICIPANTS

Douglas George Blyth Leggate *BofA Securities, Research Division - MD and Head of US Oil & Gas Equity Research*

Jason Daniel Gabelman *TD Cowen, Research Division - Director & Analyst*

John Macalister Royall *JPMorgan Chase & Co, Research Division - Analyst*

Joseph Gregory Laetsch *Morgan Stanley, Research Division - Research Associate*

Manav Gupta *UBS Investment Bank, Research Division - Analyst*

Matthew Robert Lovseth Blair *Tudor, Pickering, Holt & Co. Securities, LLC, Research Division - MD of Refiners, Chemicals & Renewable Fuels Research*

Neil Singhvi Mehta *Goldman Sachs Group, Inc., Research Division - VP and Integrated Oil & Refining Analyst*

Paul Cheng *Scotiabank Global Banking and Markets, Research Division - Analyst*

Roger David Read *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Ryan M. Todd *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

PRESENTATION

Operator

Welcome to the Third Quarter 2023 Phillips 66 Earnings Conference Call. My name is Carla, and I will be your operator for today's call. (Operator Instructions) Please note that this conference is being recorded.

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

Jeffrey Alan Dietert - *Phillips 66 - VP of IR*

Good morning, and welcome to Phillips 66 Third Quarter Earnings Conference Call. Participants on today's call will include Mark Lashier, President and CEO; Kevin Mitchell, CFO; Tim Roberts, Midstream and Chemicals, Rich Harbison, Refining; and Brian Mandell, Marketing and Commercial. 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 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.

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

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Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Thanks, Jeff. Good morning, and thank you for joining us today. We're pleased to report another quarter of strong financial and operating results, and we continue to execute on our strategic priorities to increase shareholder value. Our achievements to date have enabled us to make significant progress toward the commitments we made to shareholders a year ago at Investor Day. We're confident in our ability to exceed these commitments, and we'll provide an update today.

Slide 4 shows the evolution of our portfolio. We're much more than a refining company. We are differentiated by an integrated and diversified Midstream, Chemicals, Refining, Marketing and Specialties portfolio that generates free cash flow through the economic cycles. Our global commercial supply and trading organization leverages our assets to generate incremental value.

We continue to execute our strategy to increase more stable cash flows in Midstream. We see more growth opportunities as U.S. natural gas and natural gas liquids production is expected to outpace crude oil. The demand fundamentals are strong as NGLs and petrochemical feedstocks remain the fastest-growing segment of liquids demand.

The DCP acquisition earlier this year strengthened our competitive position by integrating our NGL wellhead-to-market value chain and adds over $1 billion to mid-cycle adjusted EBITDA. Our current synergy run rate is on pace to deliver more than $400 million. Midstream's stable cash generation covers the company's dividend and our sustaining capital. We'll continue to capitalize on our integrated and diversified portfolio to deliver results.

Moving to Slide 5. At our Investor Day in November 2022, we targeted $3 billion in mid-cycle EBITDA growth by 2025. This included NGL wellhead-to-market, Rodeo Renewed, business transformation and CPChem growth projects.

Given the substantial progress employees across the company have made, we are raising the bar. We now expect to grow mid-cycle adjusted EBITDA by $4 billion between 2022 and 2025, reflecting a $1 billion increase from our original target. This includes additional value from business transformation, midstream synergies and commercial contributions.

We're increasing the business transformation target to $1.4 billion from $1 billion. We're enhancing our commercial capabilities to extract additional value, maximizing return on capital employed and increasing refining market capture.

We're committing to higher shareholder distributions. Our new target is $13 billion to $15 billion between July 2022 and year-end 2024. This is an increase from our original target of $10 billion to $12 billion. We will return over 50% of our operating cash flow to shareholders.

Lastly, we plan to monetize assets that no longer meet strategic long-term objectives. Proceeds from monetizing these noncore assets are expected to be more than $3 billion. We'll deploy the proceeds to advance strategic priorities, including accelerating cash return to shareholders.

Slide 6 shows progress on distributions to shareholders and improving Refining performance. We returned $6.7 billion through share repurchases and dividends since July 2022, representing over 50% of operating cash flow during the same time period. Strong cash generation and disciplined capital allocation enabled us to exceed the pace to achieve the original $10 billion to $12 billion target before year-end 2024.

The increased target of $13 billion to $15 billion equates to 25% to 30% of current market cap. Our Board of Directors approved a $5 billion increase to our share repurchase authorization. This is in addition to the previous authorization, which had approximately $3.1 billion remaining as of September 30.

Since 2012, the Board has authorized $25 billion in share repurchases. These higher distributions to shareholders will be supported by $4 billion of mid-cycle adjusted EBITDA growth between 2022 and 2025. We are laser-focused on improving Refining performance.

Third quarter crude utilization of 95% was the highest utilization since 2019. Our refining system ran above industry average utilization rates for the third straight quarter. We continue to advance high-return, low-capital projects to improve reliability and market capture. We're executing 10 to 15 projects a year to improve market capture by 5%.

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Last year, we completed several projects that added 2% to market capture, and we expect the 2023 projects to add a further 1.3%. We reduced costs by $0.40 per barrel and will achieve a $0.75 per barrel run rate by the end of 2023. Our people have fully embraced business transformation, and we're raising our target to a $1 per barrel run rate by the end of 2024.

Slide 7 provides an overview of the business transformation program. We're increasing our business transformation target to $1.4 billion, comprised of $1.1 billion of cost reductions and $300 million of sustaining capital efficiencies. The incremental reductions are $300 million in costs, over half of which benefits Refining, and $100 million of sustaining capital. We are on track to achieve the targets this year and next.

Slide 8 summarizes our strategic priorities and enhancements. Last November, we announced 6 priorities to increase shareholder value. These were ambitious and consistent with investor feedback. Our achievements to date provide us with the confidence that we will not only meet these targets, but we'll exceed them.

So with the support of our Board, we're increasing our commitments to shareholders. Delivering on the commitments will generate additional free cash flow from our integrated and diversified portfolio, positioning us to increase cash returns to shareholders now and in the future.

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

Kevin J. Mitchell - *Phillips 66 - Executive VP & CFO*

Thank you, Mark. Adjusted earnings were $2.1 billion or $4.63 per share. The $9 million decrease in the fair value of our investment in NOVONIX reduced earnings per share by $0.02. We generated operating cash flow of $2.7 billion, including a working capital benefit of $285 million and cash distributions from equity affiliates of $361 million.

Capital spending for the quarter was $855 million. We returned $1.2 billion to shareholders through $752 million of share repurchases and $465 million of dividends. We ended the quarter with a net debt-to-capital ratio of 33%. Annualized adjusted return on capital employed was 17%.

I'll cover the segment results on Slide 10. Additional details can be referenced in the appendix to this presentation. This slide highlights the change in adjusted results by segment from the second quarter to the third quarter. During the period, adjusted earnings increased $304 million, mostly due to improved results in Refining, partially offset by lower results in Chemicals and Midstream as well as higher corporate costs.

In Midstream, third quarter adjusted pretax income was $569 million, down $57 million from the prior quarter. The decrease related to our NGL business and was mainly due to the timing of cargo freight costs as well as higher utility, integration and employee costs. These impacts were partially offset by higher margins from increasing commodity prices.

Chemicals adjusted pretax income decreased $88 million to $104 million in the third quarter. This decrease was mainly due to lower margins. Global O&P utilization was 99%.

Refining third quarter adjusted pretax income was $1.7 billion, up $592 million from the second quarter. The increase was primarily due to higher realized margins and strong utilization. Realized margins increased due to higher market crack spreads, partially offset by inventory hedge impacts, lower secondary product margins and lower Gulf Coast clean product realizations.

Inventory hedges and losses from secondary products mainly reflect the impact of rising crude prices during the quarter. These market factors negatively impacted capture rate, which was 66% in the quarter.

Marketing and Specialties adjusted third quarter pretax income was $633 million, a slight decrease of $11 million from the previous quarter, reflecting continued strong margins. The Corporate and Other segment's adjusted pretax costs were $59 million higher than the previous quarter. The increase was mainly due to higher net interest expense related to acquiring DCP Midstream's public common units on June 15 as well as employee-related expenses.

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Our adjusted effective tax rate was 24%. The impact of noncontrolling interest was improved compared to the prior quarter and reflects a lower noncontrolling interest since our acquisition of DCP Midstream public common units.

Slide 11 shows the change in cash during the third quarter. We started the quarter with a $3 billion cash balance. Cash from operations was $2.4 billion, excluding working capital. During the quarter, we funded $358 million of pension plan contributions, which comes out of cash from operations. That was a working capital benefit of $285 million.

Year-to-date working capital is a use of around $2 billion, primarily related to inventory that we expect to mostly reverse by year-end. We received $280 million from asset dispositions, mainly reflecting the sale of our interest in South Texas Gateway Terminal. Total proceeds from asset dispositions of $370 million through the third quarter of 2023.

We funded $855 million of capital spending. This includes $260 million for the acquisition of a U.S. West Coast marketing business. We repaid approximately $500 million of debt, mostly reflecting lower borrowings on DCP Midstream's credit facilities.

Additionally, we returned $1.2 billion to shareholders through share repurchases and dividends. Our ending cash balance was $3.5 billion. This concludes my review of the financial and operating results.

Next, I'll cover a few outlook items. In Chemicals, we expect the fourth quarter global O&P utilization rate to be in the mid-90s. In Refining, we expect the fourth quarter worldwide crude utilization rate to be in the low 90s and turnaround expenses to be between $90 million and $110 million. We anticipate fourth quarter Corporate and Other costs to come in between $280 million and $300 million.

Now we will open the line for questions, after which Mark will make closing comments.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Neil Mehta from Goldman Sachs.

Neil Singhvi Mehta - *Goldman Sachs Group, Inc., Research Division - VP and Integrated Oil & Refining Analyst*

This was very helpful, particularly the commentary on the strategic priorities. And so I want to -- on the bullet about maintaining financial strength and flexibility, you talked about moving from $3 billion to $4 billion of EBITDA growth and greater than $3 billion of noncore asset dispositions.

So wondering if you could take some time to talk about what are the key drivers of the move from $3 billion to $4 billion? And then as you identify noncore asset sales, what are some of the parameters that you're evaluating as we think about what assets could be part of that discussion?

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

This is Mark. When you think about the additional billion-dollar increments in EBITDA, that really comes from the enhanced business transformation work that we're going to do as well as the additional synergies we intend to capture from the DCP roll-up, supplemented by the enhanced capability and value creation that we're going to see out of the commercial organization.

Regarding asset dispositions, this fundamentally is about creating focus and redeploying capital. We're not going to comment on specific assets today, but we generally have some high-performing assets that may be more valuable to others and maybe more strategic to others, and we're going to explore that. And if we can capture value greater than our hold value, we'll do so. But the bottom line is this, that we're committed to managing the portfolio to drive focus that's consistent with our strategy and simplifying our business.

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Neil Singhvi Mehta - *Goldman Sachs Group, Inc., Research Division - VP and Integrated Oil & Refining Analyst*

Okay, all right. And then on the quarter itself, the Refining capture rates probably came in a little bit lower than Street was expecting. Was that just timing effects with crude? Or is there anything else that we need to keep in mind as we think about what it all means for 4Q and 2024?

Kevin J. Mitchell - *Phillips 66 - Executive VP & CFO*

Yes, Neil, it's Kevin. Let me just make a couple of comments on that. So we did have a few things moving around in the quarter that impacted capture to the negative. And so we saw regional price differentials that differed from the benchmark that we use in terms of the market crack. And so those worked against us that during the quarter, for example, the Chicago market, which became disconnected from the group, and we move product into that market.

We also had an impact from the effect of inventory hedges in a rising price environment. So that component, this all showed up in the central corridor. We expect about $100 million to $150 million of that to come back in the fourth quarter as we see the physical gain on those barrels that offsets the paper loss that we took in the third quarter.

Operator

Roger Read from Wells Fargo Securities.

Roger David Read - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Appreciate the winding up of the changes here, improvements, I should say, overall. The question I have, to start with, you mentioned $3 billion of target disposition proceeds, but you've upped your overall EBITDA target. So I'm just curious, what EBITDA is associated with those ops, if any? And what does that imply about the sort of extra growth in the overall performance of your raised EBITDA target?

Kevin J. Mitchell - *Phillips 66 - Executive VP & CFO*

Yes. Roger, it's Kevin. So just for clarity on that point, the growth that we laid out there, the incremental $1 billion is excluding the impact of dispositions. And so clearly, dispositions will reduce EBITDA. We're not giving any guidance on that at this point in time.

I mean, you can come up with an assumption on where you may think we'll be selling assets and make a multiple assumption from that. But we're not giving any specific guidance on the dispositions, other than we expect to realize in excess of $3 billion.

Roger David Read - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. And I assume based on the idea that there's always a larger pool of assets that could be sold, that's why it's unclear right now what the net impact would be.

Kevin J. Mitchell - *Phillips 66 - Executive VP & CFO*

That's right. We'll do what makes the most sense for us.

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Roger David Read - *Wells Fargo Securities, LLC, Research Division - MD & Senior Equity Research Analyst*

Okay. And then a follow-up to Neil's question on Refining margins, but maybe looking forward rather than back. The shift here, where diesel margins are well above gasoline, I think about generally a diesel yield improvement for you versus industry standards. Is that the right way to think about Q4 here? Or is there anything else that we should be paying attention to that would work against that?

Richard G. Harbison - *Phillips 66 - EVP of Refining*

Yes, Roger, this is Rich. As we've indicated over the years, our kit has shifted towards distillate production. There's nothing that's changed on that, other than some of our flexibility to move back and forth between gasoline and distillate. So we still maintain a kit that is favorable to distillate margins in the market.

Operator

Manav Gupta from UBS.

Manav Gupta - *UBS Investment Bank, Research Division - Analyst*

My question here is, and I know kind of answer, most likely you will not answer it, but we get this question a lot. A very strong result on the West Coast again. A weaker default in price environment. Is there a possibility you could let Rodeo run a little longer and capture higher margins and then just wait for LCFS to rebound later in 2024? So is there a way you could -- is there a possibility you could move the timing of startup of Rodeo to better coincide with higher LCFS prices and, in the meantime, make more money on the West Coast?

Richard G. Harbison - *Phillips 66 - EVP of Refining*

Manav, I'll start that answer and then maybe give -- hand it over to Brian here to add a little color on the backside. So at Rodeo, maybe I'll just step back a little bit and level set on everything that's going on at Rodeo here. So Rodeo, there was 2 NGOs that filed a suit against at Contra Costa County, alleging that the Rodeo Renewed project environmental impact report insufficiently address project impacts.

The ruling for the suit was received earlier this year. And actually, there were several issues in our favor, but there were 3 issues identified as insufficient in the county-certified EIR. The judge explicitly allowed construction to continue with the project while Contra Costa County works through and addresses the 3 deficiencies that were identified in the EIR.

The county actually posted that revised EIR update on October 24. That initiated a 45-day public comment period. The county will respond to the comments and then likely issue a final EIR early 2024. So right now, our project construction remains on track to complete in the first quarter, and we're committed to that time line.

However, I want to add, we have options. We've talked a little bit about this, but let me be a little bit more explicit on this one. There is flexibility to continue crude operation in the event that circumstances beyond our control prevent the start-up of the project. I want to say we are committed to the start-up of the project. But if, for some reason, we don't have that authority, we will continue to operate in crude operation.

This is a staggered conversion process. In the past, we've called this a ramp-up plan, so that creates natural flexibility for us. It allows us to continue to process crude, or it allows us to start up the Rodeo Renewed project, which, I want to remind people, that's equivalent to removing emissions of 1 million cars from the roads.

So we remain pretty confident. We remain confident, I should say, that we will start up the operation of Rodeo Renewed at the end of the first quarter. And we're focused on executing that conversion plan. But we have this planned flexibility, and we'll continue to process the crude oil, if necessary.

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Now the outlook on the market and what your -- the other part of your question is really this outlook of LCFS and -- in this relationship. I'm going to hand that over to Brian, who can explain that relationship a little bit more. It's more complicated than just the LCFS credit program.

Brian M. Mandell - *Phillips 66 - EVP of Marketing & Commercial*

Manav, it's Brian. So when you think about the RD margins, you have to think about not just the credits but the price of the feedstock, the price of the RD when it comes to market. So even though we've had lower LCFS and RINs, we've had these distillate prices that have outrun soybean prices. In fact, soybean prices are off. We have more low CI feedstocks that are making their way into the U.S. Kinder Morgan pipeline is allowing RD on their pipelines now, so that means more reach of RD into the California market for consumption.

We've had -- domestic demand is expected to continue to grow. We've converted all our stations. We're seeing RD demand in Oregon and Washington continue to mature as those programs mature. We've been seeing RD moving to states like Texas and Illinois and Colorado, where they have tax abatement and tax reduction programs. And I think traders believe that the U.S. harvest is looking good. And if you remember last year, in Argentina, they had a drought. And this year, we expect a more normal crop level condition.

And then finally, what a lot of traders and folks have on their minds is SAF or renewable jet. And as those incentives make more sense to produce renewable jet, you'll see some of this RD that's being produced move away and become SAF. So we're expecting about 200,000 barrels a day of RD at the end of this year, but we'll see some of that RD in the future become renewable jet.

Manav Gupta - *UBS Investment Bank, Research Division - Analyst*

That was very detailed, and I think the key is the flexibility part which you expressed. My quick follow-up here is, in your opening comments, you said you are more than a refiner, and yes, you have a very strong Marketing and Specialties business. Can we have some visibility, on the near and medium term, how that business is looking, both in Europe and in the U.S., if you could elaborate a little bit on the near-term outlook for that business?

Brian M. Mandell - *Phillips 66 - EVP of Marketing & Commercial*

Manav, it's Brian again. So I'll say we had a really strong quarter in the third quarter. In fact, it was our fourth best quarter on record. Q2 and Q3 are usually stronger seasonally than Q1 and Q4. And as you remember, starting 2019, we've added a lot of retail to our retail joint ventures in the U.S. We're up to 700 retail stores now, and they performed really well this quarter.

We're also focused on what we've called the last-mile strategy internally, which is getting Rodeo complex RD to the market, directly to the market, and getting that value chain value at Phillips 66. We've seen product volumes in our businesses relatively flat, but we continue to optimize those volumes through higher-value distribution channels.

So as a reminder, we have a wholesale business, we have a branded or franchise business, and then we have a retail business. And the branded or franchise business and the retail business, those margins are significantly higher than the wholesale margins.

And then finally, on the lubricants base oil business, it continues to perform really well. So I'd say, for Q4, we think that earnings will be in line with our normal Q4 mid-cycle expectations.

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Yes. Manav, I would just add over the top that Brian and his team have been just quietly and consistently executing their last-mile strategy and this opportunity to invest a fairly small amount of capital to get very high returns and to enhance our exposure to retail margins in a very accretive way. And it's -- you're seeing the value show up, and you're seeing a consistent performance there that we really appreciate.

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Operator

Doug Leggate from Bank of America.

Douglas George Blyth Leggate - *BofA Securities, Research Division - MD and Head of US Oil & Gas Equity Research*

Appreciate all the updates this morning. Mark, I wonder if I could try the disposal question again. I just want to be clear where you guys are in this process. Have you internally identified the assets for sale? I just wanted to be clear on that. And maybe what your expectations are of time line? I don't think that's been touched on, and I've got a quick follow-up on Refining.

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

The answer to the first question is yes. The answer to the second question is, it really is a function of the market appetite. We understand the value that these assets provide us, and they provide good value. So we've got to find willing buyers that have a greater affinity for those assets than we do. And so we're not in any rush. We're not performing any fire sale, but we believe there's opportunities out there in the market today to execute that plan.

Douglas George Blyth Leggate - *BofA Securities, Research Division - MD and Head of US Oil & Gas Equity Research*

My follow-up is on Refining, and I'm going to ask for a little forgiveness on this one ahead of time. But I think you know where our position has been on the strength of the Refining sector, the Refining cycle going forward, volatile as it may be. And we've kind of challenged you guys a few times on what you're assuming as a mid-cycle sustainable EBITDA for your business. So I'm curious if you could walk us through -- and expedition's always possible, given we're on this call, what the moving parts are behind the contribution of Refining to the new mid-cycle targets?

The capture rate is 1 part, but you've been running ahead. When your facility has been running, you've been running ahead for quite a while now. And similarly, your utilization rates were not great. Now they're better. Is that a big factor? I'm just wondering what the key kind of moving parts are in the assumptions and what the contribution is from Refining in your new targets.

Kevin J. Mitchell - *Phillips 66 - Executive VP & CFO*

Yes, Doug, let me try and unpack some of that. So our mid-cycle Refining EBITDA, as we laid out at Investor Day, was $4 billion. That reflects a historic average assumption around where the market will trade. And that's -- we haven't changed that assumption. What we are doing is increasing our ability to capture value across that system through lower costs and increased contribution from our commercial organization and the EBITDA uplift they provide -- that, that organization provides to the system will predominantly show up in Refining. It won't all be Refining, but it'll predominantly show up in Refining.

We haven't tried to make a call on if we actually think the go-forward mid-cycle margin environment is stronger now than it has been historically. Clearly, we've been in above mid-cycle conditions for most of this year and last year. And that's all -- we view that as upside, so we're still pretty optimistic for the near term. We're probably above mid-cycle in the near term, but our fundamental view of mid-cycle hasn't changed. But our belief in terms of what that business can do in a mid-cycle environment is going up with the enhancements we're putting in place.

Douglas George Blyth Leggate - *BofA Securities, Research Division - MD and Head of US Oil & Gas Equity Research*

Kevin, has your utilization assumption changed?

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Kevin J. Mitchell - *Phillips 66 - Executive VP & CFO*

Well, not really because, if you think back to where we were running for the years prior to the pandemic and then we took a hit during the pandemic, we're really assuming we get back to that kind of level of operations that we were at before. And so some of the things -- some of the Refining performance priorities that Rich has talked about in the past that were outlined in Investor Day a year ago, we did not include those in as increases to mid-cycle. We view that as we have to deliver on these to get back to that level of operations that we've historically been at.

Operator

Ryan Todd from Piper Sandler.

Ryan M. Todd - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Maybe if I could, a question on the shareholder return target. Thanks for the positive update there. I mean, at the midpoint, it implies, I think, roughly $1 billion a year of buyback a quarter to year-end 2024, which is a nice step-up from what we saw during the third quarter, pretty close to the pace that you've had year-to-date in 2023 in what has been a -- obviously is like -- certainly an above-mid-cycle environment. So can you maybe talk about your confidence in -- what drove your confidence in being able to lean into the shareholder return target in that way, maybe what it implies in your view of the outlook from here?

And on the -- should we think -- you've been above pace on -- your prior mid-cycle target has been above mid-cycle. Should we think of it the same way, where, if we continue to stay above mid-cycle in 2024, that you'll drive towards the upside or beyond and that type of target?

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Ryan, this is Mark. Glad to answer that question. To answer your last question, the answer is yes. If we're outperforming our -- our desire is to hit the high end of that target, and we've provided the flexibility in the event that there is less cash available because of market conditions, we can pull back a little bit.

Another thing I would point out is our $3 billion in asset dispositions, we have not factored that cash into the $13 billion to $15 billion. So there's another level of assurance there that we can hit that. And we really are focusing on the things that we can control.

As you look at the business transformation, we see those numbers, we see the reality of those numbers, and we can capture that and use that value to drive those returns. And we also see line of sight to the additional increments of EBITDA, the $4 billion that's coming into play. And of course, that could be impacted by market as well. But when you factor all those things in, the risk of underperforming is fairly muted. So we've got a high level of confidence that we can deliver.

Ryan M. Todd - *Piper Sandler & Co., Research Division - MD & Senior Research Analyst*

Okay. Perfect. That's very helpful. And then maybe just a question on the Midstream. You've had a little bit of time now with the consolidated position there, DCP under your belt at this point. Synergies have moved a little bit higher from $300 million to $400 million. Maybe can you talk about how you view the opportunity set there, both in terms of what you're seeing in terms of your ability to drive commercial improvements there and maybe incremental growth down the line?

Timothy D. Roberts - *Phillips 66 - EVP of Midstream & Chemicals*

Yes, sure. Ryan, this is Tim. So yes, great question. Glad you asked. If anything else, business transformation -- and I'll talk about that because business transformation, we started that process. And as we got into it, we just found more. We're doing the same thing with the DCP integration. So as we

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brought this thing together -- and by the way, we won't be complete with the integration. We'll get all the IT stuff done by the end of the first quarter.

And I think it's important to say that because once that's done in the end of the first quarter, one, we can get some redundancies in people that will move away in supporting 2 different systems. The other is our commercial team and our ops team will all be reading off the same screens, the single source of data. It will all be 1 versus trying to look at 2 different systems and trying to make some decisions there.

So we think the real catalyst for optimization is going to happen -- or further optimization will happen in that 1Q. But probably worth me giving an example here on the commercial side, so we're really excited about what -- this venture and putting it together. Really excited about it. And we also think the -- as we've gotten into it, as I mentioned, we really felt like we're finding more and more as we go.

And the example I want to give you is one that just came up a couple of weeks ago for us, where, commercially, we were able to move barrels. I won't put any names in here, we were able to move barrels off 1 pipe, put it onto another pipe and allow more volume to go on the pipe we moved off of. And that net impact's an additional $10 million a year for us.

So we could not have done that if we were 2 separate entities. So yes, are we believers? Yes. And do we think there's more there? Yes. And are we encouraged once we get past the first quarter about there being more opportunity? Absolutely.

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Yes. And I'd like to throw another example out there, Ryan, that last week, a group of us visited the Sweeny complex, and we got to stop by the control room that operates all of our fractionators. And I asked a couple of frontline operators how they felt integration was going, and they were ecstatic because they see the ability to improve their ability to perform. They see it in real time. They said we can run at harder rates because we get better information, there's greater collaboration. They can run without concern or surprises coming at them.

And so the whole mindset around business transformation, synergy capture, being more competitive has evolved all the way to the front line. These folks want to win, and they want to figure out every day how to do better and how to drive more synergies and capture that and deliver value. So it's real, and it's out on the front line.

Operator

Paul Cheng from Scotiabank.

Paul Cheng - *Scotiabank Global Banking and Markets, Research Division - Analyst*

A couple of questions. On Marketing, the business seems like continued to do better than expected in a number of quarters. You've been adding retail stations and everything. So should we look at that your base and then what's considered mid-cycle have a structural improvement because of your -- the way that how you guided maybe changing the way how you run or adding to the asset? And if it is the case, what is the new good baseline that we can assume?

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Yes. Paul, what I think you're asking is you're applauding the good performance you've seen in the Marketing group, and it continues to increase, as Brian and his team execute their strategy. And you're asking, is there a reset in the mid-cycle performance of the Marketing business? Is that the question?

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Paul Cheng - *Scotiabank Global Banking and Markets, Research Division - Analyst*

That's correct, that's correct. Because I mean, I think, historically, that it's sort of, like, mid-cycle is $400 million a quarter. But you certainly have done much better than that in the past 2 years. I think that 1 quarter, you can say, "Oh, maybe it's 1 risk," but it seems like it's pretty consistent that you guys have been performing better. I was just curious that, is it structurally that the business is stronger today as you add more retail station and everything? Or that this is truly that you think is just the market condition is much better than average?

Brian M. Mandell - *Phillips 66 - EVP of Marketing & Commercial*

Paul, this is Brian. I would say we did raise the mid-cycle a couple of years ago, and we'll continue to watch it. And if we need to raise it again, we will. But obviously, the business is performing better, and we're proud of the business performing better. We're going to continue to look for opportunities to add to the last-mile strategy and some of our other initiatives. So as we see that value hitting the bottom line, we'll indeed, at some point, raise the mid-cycle.

Paul Cheng - *Scotiabank Global Banking and Markets, Research Division - Analyst*

So Brian, that you don't feel comfortable that we have seen enough of the improvement, saying that the mid-cycle is that, indeed, that is now even better than what you had in mind, say, a couple of years ago?

Brian M. Mandell - *Phillips 66 - EVP of Marketing & Commercial*

I'd say keep watching the bottom line, and you'll see the dollars there. And when we feel comfortable, we'll move mid-cycle up.

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Yes, Brian never lacks confidence.

Paul Cheng - *Scotiabank Global Banking and Markets, Research Division - Analyst*

Okay, fair enough. And maybe this one for Rich. Rich, can you share with us that -- what's the Phillips 66 turnaround activity look like for next year? Is it comparing to this year, whether it's going to be higher, lower or about the same? And also, what's your view about the industry turnaround activity for next year?

Richard G. Harbison - *Phillips 66 - EVP of Refining*

Yes, Paul, appreciate the question. We generally give that guidance out fourth quarter, and so stand by for that outlook on the fourth quarter.

Operator

John Royall from JPMorgan.

John Macalister Royall - *JPMorgan Chase & Co, Research Division - Analyst*

So my first question is on the net debt target. You had guided to hitting the top end of your range on leverage by year-end. It's a pretty modest tailwind from working capital in 3Q, and Kevin mentioned you'll catch it up and get most of that 1H build back in 4Q. Do you need any help from

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price to hit that working capital number? Or could price conversely be a headwind that prevents you from getting it all back? And then does the worsening environment that we've seen here in 4Q in Refining potentially impact your ability to hit that target?

Kevin J. Mitchell - *Phillips 66 - Executive VP & CFO*

Yes. I mean, John, the market environment will impact profitability. It will impact cash generation. But the bulk of the working capital benefit we expect to see in the fourth quarter will be driven by inventory impacts, and that's pretty solid in terms of that impact. So while there will always be other parts moving around in this equation, I feel pretty confident that the top end of that targeted range is -- we'll be around about there at the end of the year. I'm not too concerned by that.

John Macalister Royall - *JPMorgan Chase & Co, Research Division - Analyst*

Okay, great. And then I was just hoping for your latest views on WCS differentials. You should get some tailwinds from the widening we've seen here in 4Q. But where do you think the differential goes from here, particularly as we get close to the start-up of TMX? Although there's some debate over the timing there, but just any thoughts on WCS as we head into next year would be helpful.

Brian M. Mandell - *Phillips 66 - EVP of Marketing & Commercial*

John, it's Brian. So like you said, the WCS dips are very wide, minus $25 now. That's a benefit to us. We're the largest importer of Canadian crude, nearly 500,000 barrels a day. The reason the dips are wide is because you have more production than you have pipeline egress. And you also have the diluent blended into -- starting in September, into the crude, which adds or swells volume. We would expect to see the dips remain seasonally wide with more barrels than egress as traders also sell barrels to meet the year-end inventories. .

TMX has announced the start-up in April. We'll take them at their word. Currently, we don't think the pipeline will run at full capacity. But if you take a look at the forward curves currently, Q2, Q3 average is about minus $15, and that's about where we think it might end up.

Operator

Jason Gabelman from Cowen & Company.

Jason Daniel Gabelman - *TD Cowen, Research Division - Director & Analyst*

The first one is on refining capture, and we've seen co-product headwinds continue now for a second quarter. Last quarter was a pretty high headwind, and then this quarter was even higher. And the oil price moving up obviously impacts the co-product headwind. But was wondering what else is going on in that bucket? If you could give us some visibility into that, and if you think any of that is structural in nature.

Richard G. Harbison - *Phillips 66 - EVP of Refining*

Jason, this is Rich. Are you asking about the co-product bucket?

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Yes. Secondary products.

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Richard G. Harbison - *Phillips 66 - EVP of Refining*

Secondary products, yes. Yes, so the primary -- in Refining, that primary mover there is petroleum coke, right? That's the product that generally drives that secondary product margin for us. And it generally lags behind crude pricing, right, and it's tied to the coal markets that can pressure it up or pressure it down based on supply-and-demand requirements there.

The other subtle component that plays into secondary products for us is NGL pricing. And that's bigger in some markets than others for us, but it certainly does play into it, and that's been depressed for some period now. And that's -- our outlook continues to not be real strong on NGL pricing on the forward curves. The balance of the secondary products, which are fuel oil intermediates and some other products that probably aren't worth mentioning, those have been relatively flat, really, over the period. So we don't see -- so we see those coke and NGLs as the primary movers right now for us in that area.

Jason Daniel Gabelman - *TD Cowen, Research Division - Director & Analyst*

Got it. And my follow-up is on the $3 billion divestment target and not really where that's going to come from, but use of proceeds. You mentioned in the earnings press release that those proceeds will be deployed to strategic priorities, including returns to shareholders. But I was wondering if there's a desire to use some of that cash to continue to grow and just, kind of, in broad strokes, what type of growth you would prioritize?

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Yes. Thanks, Jason. The cash that we might receive from those asset dispositions will be allocated consistent with our premise capital allocation process. It always includes a growth element. And if there are things that we can accelerate in our growth agenda, we can look at that.

But certainly, also would be a factor is opportunities around our balance sheet and then opportunities to hit the high end of our cash return to shareholders target. So it's all in play, just like any dollar of cash that we would turn over to treasury.

Operator

Matthew Blair from Tudor, Pickering, Holt.

Matthew Robert Lovseth Blair - *Tudor, Pickering, Holt & Co. Securities, LLC, Research Division - MD of Refiners, Chemicals & Renewable Fuels Research*

First one is on the Chem side. Could you talk about some of the dynamics in PE? Inventories have cleaned up a little bit here, but what's your margin outlook for both the U.S. and international heading into Q4? Could you give a comment on (inaudible) well above industry averages and what's driving (inaudible) And is that an overall recovery...

Operator

Matthew, unfortunately, your line is breaking up, so we'll have to move to the next question. If you'd like to rejoin the queue and potentially try dialing back in.

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Yes. We heard the first part, so Tim is going to take a shot at the first part around PE margins and inventories.

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Timothy D. Roberts - *Phillips 66 - EVP of Midstream & Chemicals*

Yes, yes, let me do that. Sorry, Matt, with the breakout there. I got the front end of it. And so I could take a wild guess on the back end, but that probably wouldn't go well. So from a Chem standpoint, look, it feels like a little bit of a broken record. We still have a supply-demand imbalance. Clearly, China, Asia is not where we'd like it to be. Over time, we expect that to come back around. But you're going to have to see a correction in the new capacity that's coming on board, coupled with demand picking up.

So we do think that's going to be hard to see at least through 2024. But to your point, I mean, when you have things like we've seen a little bit of improvement on polyethylene, you see a couple of price increases, which have been good. I don't know if they're sustainable, but nonetheless, they've come through, which has helped. And we have seen inventories coming off slowly but coming off. So from that standpoint, there's a little bit of, I'm going to say, constructive, but we know that balance has got to get fixed.

Now the one thing that I think is really important we stress here is, though, that CPChem's kit and their assets, 96% of their assets are utilizing advantaged feedstocks. So while there may be a lot of pain in the chemical space, those that are leveraging advantaged feedstocks are doing okay. We'd love to be doing a lot better, but they're doing okay. Our assets at CPChem are running hard as well as probably other their competition using light feed in the U.S. Gulf Coast and in the Middle East. But those that are using naphtha in higher-cost regions are probably challenged at this point.

Our teams are running hard, running well, taking advantage and are well positioned to actually benefit from this low-margin environment because of the feedstock we're in. So with that, we still think, though, there's some more lifting to do with regard to getting the supply-demand balance where it needs to be, but if we can continue to see some green shoots like the GDP that we saw earlier this week, maybe you put a couple of those together, and we can start moving that forward.

Operator

Joe Laetsch from Morgan Stanley.

Joseph Gregory Laetsch - *Morgan Stanley, Research Division - Research Associate*

So I wanted to just start on the demand side. So recognizing the DOE demand data has been really volatile, could you just share what you're seeing in your system across gasoline, diesel and jet? And then if possible, just your outlook for the remainder of the year, realizing that it's really volatile right now.

Brian M. Mandell - *Phillips 66 - EVP of Marketing & Commercial*

Joe, this is Brian. Let me take a stab at that. In the U.S., inventories remain low for distillate, 17% under 5-year averages. Gasoline has come back up now close to 5-year averages. So maybe starting on the distillate side, cracks are now in the mid- to high $20 range when adjusted in U.S. Gulf Coast, New York and Europe. To be reminded, European refiners need distillate cracks at higher levels because of the higher net gas price to incentivize production.

We're seeing distillate demand globally at about 2% higher than last year. In the U.S., we see demand a little bit off, although we've been watching the manufacturing sector, and we think it's probably bottomed. Truck tonnage index has begun to rebound as an example.

So for -- on our outlook for diesel, we'd say it's supported from here with the low inventories and potential shortages in Europe. And as a reminder, this is Europe's first year without Russian distillate supply, so we'll have to watch that as well.

And on the gas cracks, gas has been coming along for a ride as refiners have produced -- continue to produce diesel with the strong diesel margins. We've also had butane blending startup, which has increased the volume of gasoline. And the summer has kind of been devoid of any hurricane

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issues. What we have seen is, especially on the Gulf Coast, we started to see plants cutting FCC units. So we think that will be a help to clearing up the gasoline.

On the demand side, we're seeing global gasoline 2% over year-over-year and particularly strong; Asia and Middle East, Europe, about flat; U.S. demand seems to be about flat, too. Latin America has been really strong, about 5% over last year. So on our outlook for gasoline, we say demand relatively flat through the end of the year as the markets work to clean up some of the gasoline supply.

Joseph Gregory Laetsch - *Morgan Stanley, Research Division - Research Associate*

Got it. Appreciate your response on that. And I just wanted to ask, on the dividend, so we've -- it was good to see the increase in the target. We've touched on the buyback a bit. But could you just remind us how you're thinking on dividend growth from here?

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Yes. Our position there is consistent, secure growing dividends. We've grown the dividend every year since spin, and that's not going to change.

Operator

This concludes the question-and-answer session. I will now turn the call over to Mark Lashier for closing comments.

Mark E. Lashier - *Phillips 66 - President, CEO & Director*

Thank you, and thanks to all of you for your questions. Our integrated and diversified portfolio continues to perform extremely well and it creates a unique competitive advantage. Our strong performance and confidence in execution drives us to increase several of the original commitments in our pursuit to achieve superior returns for our shareholders.

We will return $13 billion to $15 billion to shareholders by year-end 2024. We'll reduce Refining operating costs by $1 per barrel. We'll capture over $400 million in Midstream synergies, and we'll deliver $1.4 billion of cash savings by year-end 2024.

We'll monetize over $3 billion of noncore assets, and we'll enhance our commercial capabilities, generating additional earnings. Our plans are ambitious. We're raising the bar and continuing to reward shareholders now and well into the future.

Jeffrey Alan Dietert - *Phillips 66 - VP of IR*

Thanks, Mark. If you have any additional questions, please call Owen or me. We appreciate your participation on the call today. Thank you.

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