Phillips 66

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Kristina Kazarian: Good afternoon, everyone. My name is Kristina Kazarian, and I am the head of the Midstream and Refining teams over here at CS. This afternoon I have the pleasure of introducing Greg Garland, who is the Chairman and CEO of Phillips 66. PSX is the largest publicly traded refining company in the US but, more importantly, also operates one of the most diversified networks with its key businesses spanning the midstream and chemical sectors as well.

With that, Greg, thanks so much for joining us in Vail.

Greg Garland: Good, thank you, glad to be here. So good afternoon, everyone. Nice to see you all here and thanks for joining us today. It's great to be at this conference and thank you for your interest in our company.

As I think about 2017 was a solid year of performance for our company. When you think about our operating excellence standpoint we set records in terms of personal safety, process safety, environmental excellence. It was a heavy turnaround year for us. We executed well, we battled through a hurricane, and we still ran 95% capacity utilization -- so above industry rate. So solid performance there.

We had some major midstream projects that got started up, including the Bakken Pipeline. We added capacity to our Beaumont Terminal. We did some nice projects around our refineries, particularly in Billings and Ponca City. CPChem achieved mechanical completion on the polyethylene units and got them up and running in the fourth quarter. We achieved mechanical completion in the cracker December 20th, and we hope that we get feed in this quarter, and it's at full operations in the second quarter of this year.

And then in terms of remembering our shareholders, we distributed $3 billion back to our shareholders in 2017.

So as we kind of move to 2018, it's a cash flow inflection point for us at Phillips 66. We have the contributions coming from the new assets that we've invested in over the last couple of years. We're constructive on the industry environment, just the macro environment, in terms of demand that we see. So fundamentals in terms of the refining demand, petrochemical demand, and the margins around those businesses were constructive around, and you get a kind of nice tailwind from the tax reform for our industry and for our company.

And so maybe before I go any further on forward-looking statements, I'll just remind you that actual results could differ materially, particularly if I'm saying it, and the source of those differences are found here and our filings with the SEC.

So let me start with strategy. For us, our strategy has been very consistent. It's been growth, returns, distributions built on a strong foundation of operating excellence in a high performing organization. Our strategy around growth has been focused on investing in our more highly valued, high returning, faster growing businesses like midstream and chemicals. And then enhancing returns in our base businesses in refining and marketing.

We believe that this strategy continues to create great value over the long term for our shareholders. If we can execute our growth profile in our investments, and we deliver returns that exceed cost of capital, if we can improve the base returns in the business, then we can share that success with our shareholders.

And since 2012, we demonstrated our commitment to distributions by returning $16.4 billion back to shareholders through dividends, share repurchases and share exchanges.

I always like to talk about operating excellence. We're committed to operating safely and reliably. We want to be mindful of our environmental stewardship responsibilities, and we say this because we actually believe that's the right thing to do, but we also believe that we create long-term shareholder value by getting this part of our job right.

I have a great story to share with you today in terms of our 2017 performance, say this year in the history of our company, our performance is industry-leading. Our recordable injury rate continues to improve, our environmental incidents continue to decline, and we deliver top decile performance in this area.

So our operating costs did go up in 2017. We worked this really hard. About a third of that increase was due to the growth projects that we brought online in 2017. About another third was due to turnaround maintenance in hurricane-related costs for us, and about a third was really associated with higher energy costs and some small environmental legal accruals.

We believe we can do better. We believe we can work smarter, we can be more efficient, we can be more agile, and we're working across the enterprise and looking at everything we do. We want to touch from the beginning to the end of the value chain and look for efficiencies where we can take cost out but certainly work faster, better, and more efficient. And then, as I said, we ran really well across the refining system in 2017 at 95% capacity utilization.

I want to just touch on environmental social governance. This is something that's important to us. We spend a lot of time thinking about this and increasingly more and more of our investors are interested in this. It starts with our Board of Directors. They set the tone, they set the strategy that goes down through executive management down to the people that walk the floor of our refineries.

We have an extensive outreach program and through our efforts of this last proxy season, we've engaged with owners that make up more than 50% of the shares outstanding. And to put that in perspective for you, about 25% is average in the industry.

You know, we have robust plans and policies and procedures around employee health, employee safety, and environmental. We do believe that a zero incident, zero accident workplace is achievable. And for 2017, we had the lowest number of reportable environmental events in our company's history. The last five years that number has declined by 20%. We've cut our tier 1 process safety event rate in half during that period of time.

We're one of the few companies in our space that has a dedicated research and technology effort. We focus on our technology program to help run our refineries, our midstream better, but using less energy, using less water obviously, and our technology organization is really focused in three areas. One around advanced engineering optimization for the existing businesses. Also investing in sustainable technologies, but also future growth opportunities.

And at Phillips 66 we value inclusiveness and diversity, and I put those in that order on purpose because you can't have a diverse organization unless you're an inclusive organization. And this isn't run by our HR department. It's owned by the leadership of our company. We have many employee resource groups across the company. They focus on raising cultural awareness, professional development, recruiting and outreach as well as community involvement.

We do think it's important to give back to the community. Since 2012, we've invested over $125 million back into the communities where we live, where we work, and this is for education, STEM education, but also literacy efforts, also environmental sustainability, safety, emergency preparedness, and civic enrichment.

So we've outlined our guidelines and our processes and our metrics for you, and our sustainability report is on our website if you have more interest for that.

Just a moment on the macro environment. I'm sure you've heard a lot about this today already. We do expect that production in the key shale basins will continue to increase particularly coming from the Permian Basin in 2018. There's no question that rig productivity has improved substantially, and we think that prices in the $60-ish dollar range will incentivize the upstream guys to invest.

US NGL productions continue to grow. We think it's set to accelerate given the drilling activity that we see. But across that midstream space and that downstream space, those value chains, we believe that the US is going to remain advantaged in the global energy markets. And we think that Phillips 66 is well positioned to benefit from increasing US production.

Moving on to midstream, you know our midstream business provides us with growth opportunities to create long-term value. For our shareholders, we think that our asset base, in particular provides a great platform to help drive that growth. We like the NGL value chain. It remains a focus area for us. We believe there's good opportunities and growing opportunities to export both crude and product, so we're positioning our Beaumont terminal to take advantage of this growth. You know, as part of the strategy, you see us investing in pipeline projects to transport crude and products to the Gulf Coast market area.

So the last year we've grown significantly in midstream. We completed the Bakken Pipeline, the Freeport LPG Terminal, we expanded the Beaumont Terminal. We are also expanding the Sand Hills Pipeline, we're extending Bayou Bridge Pipeline. Our Sweeny fractionator and LPG export facility have been operating very well, [at] full rates. In fact, we demonstrated capacity utilizations above designed rates at both of those assets.

Margins remain challenged across the dock in terms of the LPG exports, but when we think about the NGL production that's coming at us, particularly from the Permian, we think that dock utilization rates will improve, particularly coming in the back half of 2018 and 2019, an opportunity to earn better margins across the dock.

The Bakken Pipeline started up in June, and it's been contributing nicely to earnings during the fourth quarter. The volumes exceeded our internal forecast and expectations, and early indications show that that's going to continue into 2018.

At Beaumont, you know, we increased our export capacity from 400,000 barrels to 600,000 barrels a day during the fourth quarter of last year. We'll be taking it to 900,000 barrels a day by midyear this year.

So we started with 5.7 million barrels of crude and product storage. We're at 11 million barrels today. We have 3.6 million barrels under construction, so at the end of this year we'll be at 14.6 million barrels of fully constructed storage at Beaumont.

So our outlook for 2018 run rate EBITDA remains between $1.8 billion and $2 billion.

Phillips 66 Partners, it's an important part of our midstream strategy and executing our growth strategy around midstream, PSXP has a strong balance sheet, it has healthy distribution coverage, it's well positioned to fund its 2018 growth opportunities. In fact, we think that PSXP can meet its growth targets in 2018 without accessing equity markets other than through selective use of our ATM program.

We continue to make good progress in terms of our organic growth projects at PSXP. The Sand Hills Pipeline, which transports NGLs from the Permian Basin to the Texas Gulf Coast has been expanded. We've hit the expansion this quarter at 365,000 barrels a day. Later this year, we'll be to 450,000 barrels a day. As you'll remember, Sand Hills is a joint venture between PSXP and DCP Midstream.

The initial base is the Bayou Bridge Pipeline has been up and running, so we've been running from Beaumont to Lake Charles on our refinery there. The second part of that pipeline from Lake Charles to St. James, Louisiana, it's under construction. That should begin commercial operations by the second half of this year.

We're also at PSXP sanctioned a $200 million isomerization project at our Lake Charles refinery. This is a 25,000 barrel-a-day project that will produce higher octane blending components. PSXP is going to enter into -- or have entered into -- a long-term agreement with Phillips 66 for processing services including a minimum volume commitment. We expect this unit will start up by the end of 2019.

So we're very near the promised $1.1 billion of run rate EBITDA by the end of 2018. We can do that. We'll hit that. We're on track to deliver the promised 30% compound annual growth rate in terms of our distribution.

Beyond 2018, we get asked that question a lot. I would tell you that we expect to achieve top quartile growth in distributions in 2019 and 2020. I think the market is going to tell us what top quartile growth is. I think the important thing is between the organic opportunities we have in the PSXP portfolio and then the dropdown candidates we have at PSX, we can fund a top quartile growth rate.

DCP Midstream is one of the largest gas processors, NGL producers and pipeline operators in North America. In fact, they touch over 10% of the natural gas liquids and natural gas produced in the continental US. Strong market position in key growth areas like the Permian, the Eagle Ford, the Mid-Con, the DJ Basin. I think DCP is well positioned to take advantage of growth in US shale. We've got a strong slate of projects. We'll go through some of them today.

We've already talked about the Sand Hills expansion. But in the DJ Basin they've got two new 200 million cubic feet-a-day plants to be coming onstream. There will be more than three plants will be completed in the third quarter of this year. The O'Connor 2 plant is scheduled for completion in mid-2019.

DCP also announced final investment decision to proceed with the joint development of the Gulf Coast Express pipeline project. This pipeline is a natural gas pipeline. It will move 1.98 billion cubic feet a day on the Permian, essentially to markets along the Texas Gulf Coast.

So DCP has steadily improved its financial condition over the course of the past couple of years. They've reduced their cost structure. They've worked on restructuring their contract portfolio, and they've done a really nice job of managing through a tough market environment. DCP is emerging as a stronger, better company. Their EBITDA is growing, they're generating positive cash flow, they're making distributions to the owners. So we really like where DCP is at this point in time.

Moving on to the Chemicals outlook. You know, as you think about North America and you think about Middle East as the two places for advantaged LPG feedstocks, certainly versus Naphtha anyplace else in the world, we continue to like those two markets, and that's where the bulk of CPChem's capacity is. With accelerating US NGL production growth, we think this advantage is going to continue, you know, despite the fact there's significant new ethylene capacity that's going to coming online over the next few years.

We remain very constructive in terms of the growth outlet for petrochemicals. In fact, we think that global ethylene demand growth will continue to exceed global GDP growth for the next few years. And so this wave of cracker capacity is coming on this year and in 2019 and 2020, we think it's going to be absorbed relatively efficiently.

So moving on to CPChem. CPChem obviously is self-funded. They have a strong balance sheet. It allows CPChem to execute world-scale projects like the Gulf Coast Petrochemicals project. This project includes a 1.5 million ton ethane cracker at the Cedar Bayou facility and two polyethylene trains. They both combine to 1 million tons each at our Sweeny complex.

As I said, the new polyethylene units achieved mechanical completion. And they actually transitioned to commercial operations in the fourth quarter of last year, and they're running at capacity. So the market is seeing that capacity coming into it, and we look at the full chain ethane margin today, it's about $0.32. So margins are pretty strong in that business. It fundamentally tells you demand is really good, you know, around the world.

CPChem is commissioning the cracker as we speak. We expect that we'll get feed in the front end of the cracker this quarter, and that by second quarter it will be fully operational. And so based on the current margins we see ethane to polyethylene, we believe the project will generate EBITDA of $1.2 billion, in that range.

So if you think about the contributions from the US Gulf Coast Petrochemicals project combined with the lower capital spending at CPChem, it's going to result in a meaningful cash flow increase of distributable cash flow. So think about, kind of at the peak, CPChem's capital budget, $2 billion; this year, $800 million.

And, as I said, we like the demand profile we see for global petrochemicals. I think it's going to be a pace that will support a new wave of cracker investments. We think given the NGLs we see coming at us on the US Gulf Coast, there's going to be plenty of NGLs to feed those new crackers. We remain constructive on the second cracker at CPChem. We're doing initial work around that today. I would tell you, we probably won't FID it until 2019, so that probably means heavy lifting becomes 2020, 2021 for us in terms of the capital.

But you think about, kind of, an increasing margin environment through that period of time, more cash flow from CPChem plus the cash flow from the new project, it's going to have more than enough cash to fund its growth activities plus continue to pay distributions back to the owners.

Moving on and talking about our refining business, our refining strategy really revolves around being an efficient, low cost, reliable operator. We do maintain very strict cost and capital discipline in this business. We are willing to invest in projects that are high return, quick payout to either improve our cost structure and increase our yields there.

So a couple of examples -- at Billings last year we completed a project that allowed us to go from 80% heavy Canadian crude to 100% Canadian heavy crude. It added about 2,000 barrels a day of clean product yield also at that project. Late last year, we did a diesel recovery project at Ponca City, which allowed us to recover about 6,000 barrels a day more diesel at Ponca City.

Currently, at both Wood River and at Bayway, we have upgrades to the FCC units there to increase clean product yield at those refineries. Other examples are Lake Charles refinery today we have an ongoing investment in being able to produce more, or actually consume more, domestic crude at that facility.

So across the portfolio and opportunities kind of late in 2017, and what we see in 2018, you know, we should add about 25,000 barrels a day of clean product yield by the end of this 2018.

So systems are running well. You can see us versus the industry average there -- 95% capacity utilization and a heavy turnaround year in a hurricane is really outstanding performance in terms of our ops for 2017.

Moving on to our Marketing and Specialties business. This is a high-return business for us. It generates stable earnings. It has low capital intensity. There's a lot to like about this business. Our US marketing business has over 7,500 branded sites. It's very closely aligned with our refining and our logistics assets. It ensures ratable pull-through from our refineries, particularly for our inland and our West Coast refineries. In this business, we're focused on increasing branded volumes in the US. At the heart for this program is our re-imaging effort. You can see some of the new re-imaged sites on this slide here.

And today we've re-imaged about 1,300 sites in the US. And where we have done the re-imaging we've seen about a 3% uplift year-over-year in terms of sales on that site.

In Europe, we have a strong high return retail business that we retail under the Jet and the Co-Op brands. We've got about 1,600 sites across Europe. We continue to expand our footprint. Last year in 2017, we added 30 new sites to the Jet brand.

Okay, moving on to capital allocation. You know, we maintain a strong balance sheet at Phillips 66 by choice. You know, when you look at our investment grade rating that provides us with a very efficient cost of capital for our company. Our balance sheet management has been focused at really kind of protecting that credit rating through all points of the cycle.

But our cash flow allows us to fund our sustaining capital, which is about $1 billion a year. It allows us to pay a growing, secure and competitive dividend. In fact, we've increased the dividend 7 times since 2012, and it represents a 30% compound annual growth rate of our dividend at Phillips 66.

So historically, we've reinvested 60% of our cash from all sources back into the business, and we've turned back 40% of our cash from all sources back to investors through dividends, share repurchases and share re-exchange.

You know, as we kind of look into 2018, and we look into 2019, thinking about a couple of things. One, we're constructive on terms of margins and refining and petrochemicals. We're constructive around global demand for these products. We've got $1 billion to $1.5 billion of new EBITDA coming from the projects we've been investing in over the past couple of years. We've got a nice tailwind from tax reform. And so you kind of put all that together, and you think about that universe of investable opportunities around midstream, let's say, you know, I think we drift more towards a 50-50 allocation in 2018 and 2019. So we'll see where it goes, but certainly that seems to be what's teed up.

Okay, capital expenditures, we mentioned that -- $2.3 billion capital budget includes $600 million of capital for PSXP, growth capital is $1.4 billion. That's $1 billion worth midstream growth, about $300 million for our refinery return projects. Our sustaining capital for 2018 is $940 million.

Going forward, you should expect that the organic capability and lift at PSXP will continue to improve, and we'll grow that. And so we've grown it about $100 million per year the last couple of years.

I would tell you, long term, we think a capital spend in the $2 billion to $3 billion range is about right for our company. So think about $1 billion sustaining capital and think about $1 billion to $2 billion of growth capital at the PSX level.

And the other thing I would tell you, our capital spend, which is not consolidated, not in these numbers for our joint ventures, is $950 million this year, and we expect that to be completely self-funded.

Okay, distributions -- we think that returning capital to shareholders is an important part of value creation. It's certainly a priority for us. As I said, we've returned $16.4 billion back to shareholders through our dividends and our share repurchases and our exchanges since 2012. We base our dividend policy, we want it to be secure, we want it to be growing, we want it to be competitive. We increased the dividend 11% last year. We're working with our Board to deliver a competitive dividend again this year.

You know, we repurchased through exchange 142 million shares. That's over 20% of the shares outstanding at the time of the spin. And so when we think about share repurchases, we look at some of the parts methodology, we look at historical multiples, and as long as we're trading below intrinsic value, we're buyers of the shares. So we're buying today.

Okay, creating value. So $1.4 billion is kind of expected EBITDA from the projects that came online either in 2017 or coming online in 2018. You know, in midstream this includes projects like the Bakken Pipeline that's already online; the Freeport LPG Terminal; also continued expansion in the Beaumont terminal; expansion of the Sand Hills and Bayou Bridge pipelines.

In Chemicals most of the growth is coming from the Petrochemicals project that will be up and running at rate in the second quarter of this year. And refining, it's all around the investments we're making to access more advantaged crudes or, indeed, increase our yields around the refineries.

So I'm going to wrap up so Kristina has time to ask one question, all right? She's getting nervous over there.

So -- Phillips 66 continues to be a compelling investment opportunity. We've demonstrated strong operating performance, certainly disciplined capital allocation since 2012. I will tell you that returns matter. They always have, and they always will. I'm concerned around the midstream space. It's hyper-competitive today. Returns are challenged in that space. I still think when you look around our asset footprint that we have, we can find investable projects that exceed our cost of capital. We'll do those, the ones that don't exceed cost of capital, we will not do.

I think we've reached a cash flow inflection point at PSX. You know, capital has come down, cash flow is coming up, and nice tailwind from tax reform.

And then, finally, I would just tell you, I think that we have the right combination of people, portfolio, and projects that we can continue to capture and create value for the shareholders of Phillips 66. So, with that, I'll conclude. Thank you for your attention today and for being here. Kristina, it's all yours -- I'm all yours, how about that?

Kristina Kazarian: Sounds good, I'll open it up for Q&A and maybe go to the crowd first, if there are some. I can always fill in. Would you like to go first?

Unidentified Audience Member: Thank you for coming. Thematically, some of your peers have been commenting about the IMO regulations. I think Kristina wrote a note about it. I haven't had a chance to read it yet. So what is your take on that from a PSX perspective?

Greg Garland: Well, you know, so first of all, I think there's a variety of opinions out there – I'm the Bear, Jeff's the Bull on that. But, clearly, I think it's directionally constructive for distillate cracks. It's probably -- you think about 4 million barrels a day and some portion of that is going to be scrubbers. There may be some cheating, there may be increased demand for distillate, but that's all probably directional.

You know, whether it's $5 or $15, I don't know the answer to that. You know, I suspect that you won't see us investing in that. You may see us swing the portfolio. Today we, like most of the industry, run in max gas mode, right? But we can swing from max gas to distillate, and we can move the portfolio 4% to 5%. You know, that's a hidden value creator for us without spending any capital at all in terms of help capturing that opportunity.

And, secondly, you have to think that fuel oil is going to get depressed in this environment, you know, that heavy spread is probably going to be wider not narrower. As you think about that, you think about the ability to consume this in the cokers. It's 8 million barrels a day of coking capacity globally. You know, there's probably 2 million barrels a day, obviously it's got to find a different home. And so that balance equation, we like that, too, in terms of PSX.

But in terms of building more hydrocracking capability or investing in cokers, probably not on the radar screen for our company.

Unidentified Audience Member: And then I think it's been a couple of months, it was the first week of December you talked about the Cedar Bayou construction that's going to begin in Q1. I presume everything continues to go on track there?

Greg Garland: So, you know, Cedar Bayou was heavily impacted by Hurricane Harvey. I think we're talking about getting -- it's back up and running. You know, at the end of last year, the cracker itself, the construction is wrapping up at the cracker this quarter, and we're essentially doing the commissioning work. So we achieved mechanical completion December 20th. So there's a little bit of construction left but not much, and you'll see us put feed in this quarter to the cracker. So beyond that, there's not a lot of construction going on at Cedar Bayou.

Unidentified Audience Member: Hi. So two things. So one, I guess, when you look at, kind of, global refining today, is everyone kind of running max at diesel? Or do you see room for people to continue to kind of increase diesel production without really much investment? That's one. And then, two, when you look at the ethylene market, I guess you said you're pretty bullish. What drives that other than, I guess, the price is a lot higher today?

Greg Garland: I'm sorry, in which market?

Unidentified Audience Member: The ethylene and polyethylene market.

Greg Garland: The ethylene and polyethylene market? Okay, we'll take them one at a time. So we're running max gas mode today. We're about 42% gasoline, 30% diesel. We can flip that. One of the things you think about the economy, it looks like, to us, that gasoline demand, for the most part, is flattening out. We'll see. We keep forecasting it and we keep getting it wrong. It keeps growing, which is a nice problem to have, but ultimately between fuel economy standards, bios coming in the mix, whatever, I do think that gasoline demand and for transportation fuel kind of levels off or starts to decline. So take a five or 10-year look, you've got to get there. This distillate, on the other hand, we think is growing. There's no question, you know, with the resurgence of the E&P activity we're seeing distillate demand going up.

The economy is doing really well. As you know, distillate demand is about 80% correlated with economic activity. As we think, kind of, globally, we have the US, we have Europe, we have Asia economies kind of all growing in sync for the first time. It's been since 2008 since we've seen that. Many of us have kind of forgotten how to act in that kind of a world. But we fundamentally like the demand profile that we see out there.

So shifting to petrochemicals, you know, look, it's growing faster than GDP, so pick your GDP growth number, but people are pretty bullish right now on GDP growth. You know, over the course of the next decade or couple of decades, you've got billions of people coming into the middle class in India and China, throughout Asia. And they're all going to be consumers, and so we think that bodes well, long term, for demand for, you know, kind of, the market customer-facing products like the polyethylene that we produce at CPChem. So, I guess, I don't know, if we're bulls on growth or not, but we're very constructive on growth.

Unidentified Audience Member: This is kind of on that front -- can you say anything about same-store sales, what you're seeing in the first quarter for gasoline and diesel? The EIA data is all over the place.

Greg Garland: No, no it is, so miles driven is up, right? And the demand would believe you, at best, it's flat. I think that's probably consistent with what we're seeing in the first quarter.

Kristina Kazarian: Also, in a big picture, I wanted to end it off -- a lot of your talk talks about the cash flow inflection point that you guys really feel like you're approaching. At the same time, when I hear some of your slides I think about a lot of opportunities facing you, whether it's a second cracker or whether it's Enbridge talking about wanting to sell their DCP business, whether it's another frac.

How do I merge all those concepts together and maybe talk a little bit more about your one- to three-year capital allocation strategy?

Greg Garland: Yes, I don't think it changes. I don't think, really, anything changes. We're still -- we think that a $2 billion to $3 billion capital program is a right sustainable level of capital for us. You don't have to go back that far, and we're spending $6 billion a year. We had pushing $8 billion of cash, and we pre-invested to really jumpstart the MLP growth. We're there. You know, we've hit where we want to go, and we'll continue to grow at top quartile rates at PSXP. But we don't need to fund those big programs.

So I think a very disciplined approach to capital, you've got to do projects that exceed your cost of capital to create value for your shareholders. And, you know, kind of looking around that opportunity set out there, and I just don't see that many things I really want to invest in. So I think 2018 and 2019, we're going to be in that range and probably to the low end of the capital guidance range.

Kristina Kazarian: Great. Well, thank you so much.

Greg Garland: Yes, thank you.