Phillips 66
2012 Barclays CEO Energy-Power Conference
Greg Garland, Chairman and CEO, Phillips 66

Sept. 5, 2012
11:05 a.m. ET

Paul Cheng: Good morning. Our next presentation is Phillips 66, the latest and also the biggest independent refiner. While there is a new kid on the block, there's -- at the same time there has been in the industry for many, many years or as that case, as to say. We are extremely happy to have Greg Garland, the CEO and Chairman with us. Without further delay, Greg.

Greg Garland: Thank you, Paul, and thank you to Barclays for the opportunity to participate today in this conference. We're pleased to be here and to share with you the Phillips 66 story and update you on our strategies and kind of where we're at for the Company.

So we have the obligatory Safe Harbor statement. As you know, I may make some forward-looking statements today and may address some of those in the question and answers and it's possible the actual results could materially be different. If you want to see the explanation of that, it's in this statement and in our SEC filings.

So we're off to a good start. I think we're operating well in what I describe as a positive margin environment for our Company. The spin transaction was executed flawlessly. I think it's a real tribute to the dedication and the capability of the Phillips 66 employees. They did a great job of getting our feet underneath this. The Company has stood up. We're ready to go. The systems are operating well. We've been running well and capturing good opportunities in the market.

We think we have a clear strategy in terms of capturing growth opportunities, margin enhancement opportunities, and driving return improvement in our business. I would also say that we are very purposeful and thoughtful. We're very purposeful and thoughtful about the assets that we've put in to Phillips 66 as we started the Company. We think that the three pieces of our business, the Refining and Marketing, Specialties, Transportation; the Midstream business, and the Chemicals business are more valuable together. We think value is created through lower risk, lower cost of capital, the ability to see across the entire value chain. We think it makes us better allocators of capital ultimately. We think you'll see the benefits of our management of these three businesses as we go forward.

We're going to be very disciplined in how we allocate capital at Phillips 66. We understand that there's a balance required between growth capital and distribution to shareholders. I think we've kind of illustrated that commitment through the first dividend announcement and the $1 billion share repurchase program that we announced back in June.

We feel strongly that superior returns create superior value. You'll watch us, we'll chase returns. We think that this combination of really returns, growth, and distributions is the right strategy for our Company.

We think we have a unique and unparalleled platform for success at Phillips 66 in that we have the platform that we can grow and create value with the Company. We have a very competitive refining and marketing transportation business. It's in all the regions of the US. Have a strong niche position in Europe. We have a good Specialties business in our R&M business. We also have a global Chemicals business. We think it's the best chemical company on the planet. It's a recognized leader in olefins and polyolefins. We have a Midstream business that's sitting on top of some of the most prolific shale plays in the US. We'll talk more about that.

You can see on the graph on the right-hand side of the slide, this business was, is, and probably always will be a very volatile business. You can see in 2009 adjusted earnings of about $500 million, $3.6 billion last year, through the first 6 months of this year, $2.2 billion. So we think in a volatile business like this, you have to have a strong balance sheet. You have to have financial flexibility. Gives you confidence to pay dividends, increase that dividend to strategically invest in growth across the cycle. We see our balance sheet and our size as competitive advantage for our businesses.

The other thing I would say is that all three of these business segments, our R&M business, our Midstream business, our Chemicals business, are well positioned to take advantage of the prolific shale plays and the Canadian heavy that you're going to see coming down in the lower 48.

As we look at our business relative to peers, certainly our Chemicals business, Midstream, top tier performance; refining, mid-pack. We have some work to do in improving our base refining business. We'll talk about that today. A big source of competitive advantage we think we can have in our business is the access to advantaged crudes. It's 75% of our cost structure, a lot of work going across the Company in accessing these advantaged crudes.

One of the things that I like about our Company is we have a long legacy of being good operators. When you think about operating excellence, I have a real passion for this. It's the foundation that provides the opportunity to create sustainable value growth. I'm proud of our progress here. We have more work to do. We think an employee can work a day, a week, a month, even a year without getting hurt. I have an expectation employees work their entire career and not get hurt in our Company. So the target is zero.

When we talk about operational excellence, it's holistic in our view. It is personal safety. It's process safety. It's environmental excellence. It's reliability. It's cost management. It's all those elements wrapped together. You can see we've improved reliability over the past couple of years. We operate above industry average rates. Part of our DNA and our culture, our heritage is just stringent, prudent, detailed cost management. We have all grown up in commodity businesses. We understand the importance of cost, cost structure, and managing those costs every day.

We think about refining and marketing. We have the broadest geographic segment within our peer group. We think this geographic footprint gives us a very competitive advantage. It's a great platform for capturing advantaged feedstock and optimizing the product placement that comes out of the refineries. You can see 15 refineries, 11 in the US. We have substantial infrastructure that supports the refineries in terms of 15,000 miles of pipe, 50 some odd terminals, barges, railcars, etc.

This map highlights the geographic diversity of our refining business. About 33% is on the US Gulf Coast, 21% is in the Midcon. So you think about that central corridor, 54% of our capacity is in the central corridor. 16% is on the West Coast, 11% since we have one refinery, Bayway, on the East Coast, about 19% of our capacity is international.

Stop and just give you a quick update on Alliance. As you know, Isaac went right over the top of the Alliance refinery. We got back in the refinery on Wednesday afternoon. Some minor damage in terms of insulation blown off of towers, but really the refinery came through in really good shape. Back side of the storm created flooding in Plaquemines Parish. It overran a levy. We had about a 100 foot breach in our dike. So we got water into the refinery. By Thursday afternoon, we had managed to breach that. But we had about a foot to a foot and a half of water in the refinery. By Saturday, we had pumped all that out. No equipment damage really. We had hardened the refinery after Katrina. We had raised and elevated motor control centers, control rooms, etc. So really no equipment damage. We got a boiler started up Sunday night. We got gas restored on Sunday, power restored on Tuesday. So we're in startup mode and we expect in six to nine days, we'll have Alliance up and running. So really we came out well compared to the Katrina event back in 2005.

Right-hand side you can see the global realized crack spreads for the business. You can see an improvement there. Well a lot of that was given to us by the market, market-related. Part of it is the portfolio actions we've taken, shuttering, selling Wilhelmshaven and exiting Trainer, etc. Capturing advantaged crude as we've seen that come into the portfolio. So good improvement.

One of the things that we have that we like to talk about is our marketing and specialties business. When you look at this, a significant portion of the earnings of R&M are not related directly to refining. You can see this as a very stable business for us, kind of $500 million to $700 million of net income. When we talk about marketing in the US, we do not own any stations. We market through branded wholesale stations in the US. There's about 8,000 branded stations that are marketed under either the Phillips 66, the Conoco, or the 76 brand. About half of our marketing margin is actually moved through unbranded wholesale. In Europe, we do sell direct. We have about 900 stations in Germany and Austria, another 250 stations in Switzerland in a joint venture with Coop. In Germany and Austria, we -- Switzerland and UK we market under the JET brand. Extremely high market efficiency out of these stations. Strong ROCEs in excess of 30%. We like the European retail presence. We look at the European market. It's a lot like North America. It's really a flat to declining market. So we will grow, but we'll grow marginally in the European business. We're also a large top three supplier of lubricants in the US, the other business we like and we'll continue to grow that business.

I wanted to highlight our specialty coke business for you today. As we think about specialty coke, really two types, anode coke and the needle coke. Anode coke is critical to the production of aluminum. We think the aluminum market grows about 5% to 7% a year. We have about a 7% market share of global demand in this business. So this business provides stable earnings and really slightly stronger earnings in the base refining business. We also make a needle grade coke at two of our refineries. It's the only type of coke that's used to make graphite anodes in the steel recycling industry. This industry is growing about 2% to 4% a year, very high profit for us. This is based upon proprietary PSX technology. So you'll see us grow this business over time.

So we're the only downstream independent company to have a significant ownership in a petrochemicals business. We conduct our chemicals operation primarily through Chevron Phillips Chemical Company, 50/50 JV with Chevron. This joint venture is 12 years old. It stood the test of time. We have a great relationship with Chevron. We like the management team. We think they're a very talented group of individuals. We think there's good value between Phillips and Chevron as we manage the joint venture. We're completely aligned in terms of the growth profile, significant organic investment opportunity and growth in CPChem over the last ten years and certainly in the next ten years that we see.

The other thing that I'd say is that CPChem's success and I think is partly based upon their proprietary technology. We think this ensures low cost. It ensures competitive position via the other peers out there. Much like what we're pursuing in the R&M business, the chemicals business is pursuing advantaged feedstock. Last ten years building projects in the Middle East. We think the shale plays in the US present a new opportunity for advantaged feedstocks here in the US. Most of our US capacity is ethane based. That's a big advantage that we see going forward.

In Midstream, we primarily conduct midstream through our 50/50 JV with Spectra through DCP. Again, 13-year old joint venture, stood the test of time. We like the management of Spectra. We get along. We understand the strategy and agree on the strategy going forward for DCP. DCP itself is, we think, one of the premiere midstream companies in North America. They touch about 400,000 barrels a day of natural gas liquid, 7.1 trillion BTUs of gas, 61,000 miles of pipe, 12 fractionators. We also hold some assets outside of DCP. So they're 100% PSX. We have interest in 3 fractionators and some pipe, about 100,000 barrels a day of fractionation capacity. This business has provided strong returns historically and we're putting significant capital into growing the Midstream business.

I would just say over the last 3.5 years, about 40% of our adjusted earnings came out of R&M or specifically refining. Then you can see 60% came out of marketing specialties and other businesses, our Chemicals business and Midstream business. The point here, we have a differentiated portfolio. We like this portfolio. We think it's a competitive advantage for us.

So here's our strategic priorities. Drive returns on capital. Make sure we deliver profitable growth and grow shareholders' distributions. We believe that fundamentally that superior returns drive superior value creation and shareholder value. One of the largest levers that we have in our R&M business is around advantaged crude capture. We're going to talk a little bit more about that in the presentation.

We'll continue to pursue advantaged feedstocks in the chemical space. As we look around the R&M business, we see it essentially as kind of flat to declining market. So you will not see us invest capital in adding capacity in refining. You will see us invest capital around infrastructure, to put advantaged crude to the front end of the refineries or export infrastructure to export product out of the back end of the refineries.

The thing I would say is we have good solid investment opportunities in both Chemicals and Midstream, a lot of it being generated by the shale plays here in the lower 48. Then fundamentally, we believe that shareholder distributions have to be an important part of the strategy. We believe in a competitive growing dividend over time. As we generate excess cash, you'll see us do share repurchases and we will also consider special dividends.

Talk about capturing advantaged feedstock. As I said, this is about 75% of the cost structure in our refining business. It's the single biggest lever that we have to create value in the base refining business. $1 a barrel across our system is worth about $500 million of net income to us. So it is significant. Today, PSX is the largest importer of Canadian heavy crude in the US. In July, we ran about 130,000 barrels a day of shale oils. We ultimately plan to take that to 460,000 barrels a day.

We think it'll take us a couple years to accomplish that. We announced the acquisition of about 2,000 railcars. That gets us about 120,000 barrels a day of additional capacity for shale. Probably that's going to go east and west to our refineries on the West Coast and East Coast. So far, we've had about a half a percent ROCE improvement with this. We think we can drive 2% to 3% ROCE improvement with the shale crudes.

As we think about our capital program and really shifting investment to the higher returning segments of our portfolio, R&M is really around investing in marketing, specialties and transportation, reliability improvements. CPChem we have opportunities on the US Gulf Coast, DCP opportunities in infrastructure. So over time, what you would see, and this chart actually shows the very beginning of that, is a ramp up in the spend in Chemicals and in Midstream versus kind of holding our investment in the base refining business at DD&A levels, 900 million a year roughly. That's the sustaining capital for us and increasing slightly the spend that we've got in our marketing and transportation segments.

So as you think about the portfolio then over the next say five to ten years, you would expect that the proportion of the R&M would stay flat on an absolute basis but on a proportional basis would actually go down over time and the investment in Chemicals and Midstream would then increase.

The other way that we're looking at increasing our return on capital in the base R&M business is increasing clean product yield. You see a nice track record here. As we start up Wood River CORE, we premise about a 5% increase at Wood River CORE. We've seen that with the project in about the 1% increase you see between '11 and '12 year to date is primarily associated with Wood River starting up.
We think we can drive this another 1% to 2% without significant capital investment.

Want to give you a quick update on the CORE project, $3.8 billion at the Wood River facility. I think it was a good investment. You can see on the slide that the first half benefit to Phillips 66 was $200 million pretax. That's slightly better than expectations. When we approved the project a couple years ago, we're seeing the increase in clean products that we premised. We're running about 166,000 barrels a day of Canadian heavy now at the facility. So it's been a good solid project for us.

One of the other things we're looking at is towards the back end of the facilities is increasing our capability to export from our coastal refineries. Last year, we exported about 100,000 barrels a day. We have the capability this year to, at the end of this year, to about 155,000 barrels a day. By the end of 2013, we plan to be about 220,000 barrels a day. So that's about 15% of our North America capacity to export. We'll watch that. As the opportunity is there, we will certainly export those products. As we have the opportunity to move those into higher value in the US, we'll do that. But we'll play the arbitrage and we'll go to the highest value market that we see.

So as we start thinking about growth and shifting to the growth side of the story, we're interested in growing our capacity in Chemicals and our Midstream segment and we also want to generate higher EBITDAs out of higher returning assets. So as we think about moving forward and looking at the Chemicals business, these shale plays in the US is creating a huge opportunity for the US chemical industry. We want to be a big part of that. So, one of the things that we're doing, we're increasing fractionation capacity at CPChem's facility at Sweeny, about a 20% increase in frac. We're also investing in a 1-hexene plant, 200,000 ton a day facility. Think of that as a specialty chemical, very nice returns in that business. Then we've announced a $5 billion new grassroots facility at -- well actually split. The cracker will be at our Cedar Bayou facility. The derivatives, which primarily are polyethylene, will be at our Sweeny facility in Old Ocean, Texas. We expect that the cracker will be up in 2017. We think we'll be one of the first of the new grassroot crackers to be up in 2017.

CPChem spent the last decade doing mega projects. When I talk about mega projects, I'm talking about $1 billion plus project. We've done three in Saudi. We've done two in Qatar. In Saudi, we're in the process of starting up the third one. In fact, it's running today. We're loading pallets, shipping it to customers. So that facility is started up. CPChem has a 35% ownership in that. The original two Saudi investments is 50/50 ownership. Then in Qatar, we have two facilities, Q-Chem I, Q-Chem II, 51/49, 49% CPChem, 51% State of Qatar.

We're pursuing other opportunities in the Middle East. We like the Middle East. We're very comfortable operating there. We've had a good track record of success there. Advantaged feedstock is the real key there and then access to the growing markets in Asia.

So we move to the Midstream. When we think about profitable growth in Midstream, we have about $4 billion to $6 billion of projects, $4 billion has been sanctioned by the DCP board. This is in infrastructure, gas gathering, gas processing, NGL logistics. This is going to be spent over the next three to four years. Now there's two big pipes in that that drive a lot of that investment. One is the Sand Hills pipeline. This is 720 mile, 20-inch pipeline that really moves raw NGL from the Permian now through the Eagle Ford to Mont Belvieu. That's a $1 billion type of investment. Then we have the Southern Hills pipeline that really connects the Midcon with Mont Belvieu. It's about 800 mile. It's a combination of pipes that range from 8 inch to 20 inch. Ultimately, more than doubles the NGL capacity that DCP has today. Also investing in new gas infrastructure. We're investing in new gas processing plants. About 700 million cubic feet a day of new gas plants are either under construction or ready to start construction in the next couple years. So a significant growth profile for DCP.

We think DCP is well positioned. You can see from the map, the legacy assets of DCP overlay all the hot shale plays in the US. We think you get the most leverage by investing into your existing infrastructure. Everything is chock-full today. I mean the infrastructure coming out of the Permian, out of the Midcon is just completely full for DCP. That's the need for driving these new investments.

One of the things that we wanted to do for you today is to give you a feel for our strategic initiatives in how are we growing EBITDA. So what we did is we took 2012 margins and we normalized '10 and '11 for you to give you a feel for how the EBITDA is being driven. You can see that roughly -- a little over half of it is in the core R&M business, so it's the Wood River CORE project. It's the advantaged crude capture. It's the export that we see, clean product yield improvements and driving this. Then you can see the Q-Chem investments in the Middle East in Q2 in the Saudi SPCo. investment. Then we can see the NGL logistics. This is around $1 billion of EBITDA improvement versus 2010.

I said earlier that this business was, is, and always will be a volatile business in our opinion. Given the volatility of this business, we think it's an absolute must to have a strong balance sheet and financial flexibility. We want to be able to pay a dividend through the trough, increase that dividend through the trough. We're absolutely committed to doing that. You can see we've laid out for you kind of '09, '10 and '11 and what the cash generation has been in this business. In the dark grey, is the dividends, $500 million a year. The lighter grey is the sustaining capital, about $900 million a year. So think about $1.4 billion of sustaining capital and dividend requirement that we have to cover.

Mid cycle cash in this business should be about $3 billion a year. So we're going to have about $1.5 billion to $2 billion a year of free cash above our requirements for sustaining capital and for dividend. That gives us a lot of confidence that we can grow our dividend over time, gives us confidence to make strategic investments, probably pay down some debt and do other distributions to shareholders whether that's in the form of share repurchases or special dividends.

We absolutely believe that we can create value in the new PSX and we're going to do it by being very good allocators of capital. We're known as being a good partner. We're good operators. We value operating excellence being there every day to run our businesses well. We believe that as we shift returns into higher performing segments of our portfolio, we will move the ROCE. We believe as we capture advantaged crude that we will drive margin improvement in our base business. We're 137 years of industry experience and innovation. We're Phillips 66 and we're going to take this classic in a new direction.

So I think I'll stop there and I'll be happy to take any questions that you may have about Phillips 66.

Paul Cheng: Thank you, Greg. We probably have time for a couple question and then move to the breakout session. Any questions? There's a question, here.

Unidentified Audience Member: Sure, slide 18 says rationalize non-core assets. Can you just elaborate on that?

Greg Garland: So, over time we – within the last six years we've sold $10 billion of $50 billion worth of assets. You should expect that over time that we will always work the tail in our portfolio. We're not going to be real specific about which assets that we might sell. But you should expect that we'll always manage that core. We did have Alliance on the market. The offers came -- we had 20 people go through the data room. We probably had four offers, none really serious. We think that with LLS and where it's going, we see more opportunity for Alliance in the future than we saw a year ago when we put it on the market. But yes, you should always expect that we're going to have some rationalization of the portfolio.

Paul Cheng: Any quick questions, here? If not, we're going to move to the breakout session (inaudible).

Greg Garland: Great. Thank you very much.