03-Sep-2014

Phillips 66 (PSX)

Barclays CEO Energy-Power Conference

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MANAGEMENT DISCUSSION SECTION

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Good morning. Our next presentation is Phillips 66. With great pleasure, we have the CEO and Chairman, Greg Garland with us. The last two years since the spin-off from Conoco, Greg with his leadership and the rest of his team has done phenomenally in the company and being considered one of the best operating team and also then one of the most financial savvy.

So without further delay, let me welcome Greg and share with us all the exciting developments.

Greg C. Garland
Chairman & Chief Executive Officer, Phillips 66

Thanks, Paul. Hey, good morning, everyone. Pleasure to be with you here at the Barclays Energy Conference. I told Paul, I said, you're getting reputation. You're the guy that ruined summer because this is the end of summer for us all as we get back from summer vacations, get started with the Barclays conference, but we were really pleased to be here, Paul. Thank you and to your team, you do a great job with this conference.

So let's get started. Safe Harbor statement, during the course of the presentation today and during the Q&A later, we could make forward-looking statements. Material results could be different, the actual results could be different and the source is different since we're here, our filings with the SEC.

So here is our strategy, growth, returns, distributions. We have an unyielding commitment to operational excellence, which for us is personal safety, process safety, environmental excellence reliability, cost management and a commitment to have a high performing organization. So right people, at the right place, at the right time to execute the plan, and having people that know how to win and are committed to differentiating shareholder value. So that's kind of the strategy.

As we look at our refining business, it's run well, it's optimized, it's minimized capital investments. We won't invest in advantaged crude at the front end, exports on the backend, yield capture, energy efficiency, but really very disciplined capital investment in our refining business. Midstream business, aggressive growth and we'll go through that today as we move into the presentation.

Chemicals, aggressive growth; selective growth in our marketing and specialties businesses. We're executing well. We've identified lot of growth opportunities in the company, we'll talk about today. A lot of them around midstream and logistics, ultimately destined for our master limited partnership. We've raised the dividend 28% in May and June. The board approved additional $2 billion share repurchase, so we're at $7 billion total authorization on share repurchases.

We strengthened the balance sheet, so we're at the low end of our 20% to 30% debt-to-cap ratio, and our strategy is about transformational change. As you think about moving from essentially a refining company, where most of the income is refining, to go into about a third refining, we plan to double the enterprise value of our company by 2018 compared to the historical mid-cycle average.

Just a word about operational excellence, we have the energy to lead our industry in this space. We're performing well, executing well and that's continued into 2014. Look at Phillips 66, our total recordable incident rate is 0.18, which is about 18% better than 2013. So, we continue to do really well in this space.

If we turn to our internal refining metrics, by any measure on our refining side, we continue to improve our environmental footprint. In the last 10 years, we've invested more than $1.5 billion in process control and in systems that have allowed us to reduce our environmental footprint. That's a very important thing for us as we move forward. So, we want to lead our industry in operational excellence.

So thinking about our plans, our plan promises continued growth in energy availability and supplies in North America. Thinking about crude production in the U.S., starting to push 10 million barrels a day by the end of this decade, natural gas liquids going from somewhere just over 2 million barrels a day to 3.5 million barrels a day to 4.5 million barrels a day, natural gas production to 80 billion cubic feet a day by the end of the decade, so significant growth.

This is creating opportunities for infrastructure investment. So in our midstream business, it's gas gathering and gas processing, crude pipelines, crude gathering systems, terminals, NGL fracs, export facilities, just billions of dollars of investment there.

And then this big increase in natural gas liquids from 2 million to 3.5 million to 4.5 million barrels a day is creating opportunities, obviously, for exports of natural gas like the propane and butane, but also feedstocks for petrochemicals, and so significant growth opportunities for our company and for our industry in terms of petrochemicals. Our view is, over the next decade, the best place to make petrochemicals is going to be in the Middle East and in the U.S. Gulf Coast.

So as we consider the energy landscape, we think about the value chain and the value capture opportunities this way. We think that the value capture between NGLs and crude is more sustainable and is more durable than the value capture opportunity between crude and refined products and, hence, that's why we're investing more in midstream and logistics and petrochemicals preferentially as we try to make the transformational change of our company.

We understand that demand for refined products in the U.S. is going to be probably flat to declining and so access to export markets for refined products is going to be important. So we'll show you our plans around that today.

Our capital plans do include the required funds to make the builds for regulatory mandates whether it's Tier 3 gasoline requirements, the flare controls, coker vents, et cetera, but we've got that built into the plant. This is a business that has inherent risk.

We have a management team that is highly experienced at managing risk, whether it's commodity risk and the day-to-day risk, or it's a risk of managing hydrocarbons on a day-to-day, whether it's executing large complex mega billion dollar projects. We have a very well seasoned, well fully capable management team to do that.

So, when you look across our business platform, either in the midstream business or refining marketing, specialties or chemicals, we think that we have the human resource potential that we need to execute our plans.

So, let me move on and talk about our capital program. Our total capital program for 2014 is $5.8 billion. That includes $1.9 billion of our proportional share of the equity share joint venture, so WRB, ECP and CPChem.

Our regional budget at Phillips 66 was $2.7 billion. So, that excludes the equity JVs. In July, our board approved a $1.2 billion increase to that, really in two pieces. $900 million was around a list of acquisitions, which we'll go through some of those today during the presentation. $300 million of that was really for acceleration of workaround the Sweeny Frac and the Freeport LPG facility.

So, I'll talk about Beaumont spectrum, Sweeny Cogen. We took out our other equity owner, 50% owner of the 440 megawatt Cogen facility at Sweeny. When you think about the existing investment we have, the new investment going in at Sweeny, both from PSX and also CPChem, we want to make sure we harden that electrical infrastructure.

You remember in the first quarter and second quarter of last year, we had some issues, mostly related to our third-party providers. We want to ensure that we've got that well in hand and we don't have that ever happen to us again and so that was part of the reason for that. Explorer, we had the opportunity to pick up additional 5.8% interest, bringing our interest to 19.5% on Explorer Pipeline.

So, if you look at our investments over the next few years 2014, 2015, 2016 actually into 2017 as these projects start coming online, on a price neutral basis, we expect EBITDA will grow by $2.5 billion at PSX.

So, here's some new information versus the Analyst Meeting in April. We showed you $1.5 billion of MLP-able EBITDA at PSX Midstream. What we've done is we extended out 2017 to 2018 to get a full year. We've shown the impact of a second frac and also the Beaumont terminal, but we're showing $2.3 billion of EBITDA, total MLP-able EBITDA in our midstream segment.

As you start, today, we have about $500 million in midstream and that excludes the EBITDA from DCP, about $250 million of EBITDA that's embedded in our refining business today. So, you have roughly $1.6 billion of growth, mostly around NGL and transportation and logistics. I would say the majority of this EBITDA is fee-based.

So, I'm going to talk about the NGL opportunities on the Gulf Coast. Obviously, we have the one-third interest in Sand Hills and Southern Hills, so those are in service, ramping up as per schedule. We talked about our Sweeny project on the frac. We're going to build a 100,000 barrel a day frac at Sweeny, 150,000 barrel a day export facility at Freeport, about 250 miles of pipelines that connect Belvieu and those areas.

We're going to build a 450,000 barrels of natural gasoline storage and about 550,000 barrels of propane storage. So, a significant project, all in $3 billion to $3.5 billion. We expect $400 million to $500 million of EBITDA associated with this project.

We also, as we evaluate the opportunity, see the need for a second fractionator. We're going to FID that in 2015. We expected that that will be up in 2017. Estimated EBITDA from that will be $300 million to $400 million.

So, the Midcontinent is an important area for our company, three refineries or interest in three refiners, 485,000 barrels a day of capacity, about 22% of our global refining capacity, over 3,000 miles of pipes, 20 terminals. As we think about the opportunity, to just give you an example of what we're doing in the Mid-Con around crude acquisition, Ponca City, we've invested in truck loading, unloading capabilities of 70,000 barrels a day. By midpoint of next year, 100,000 barrels a day, the Magellan pipe to another 20,000 a day going in Ponca City.

So, we're buying indigenous Oklahoma crudes at the wellhead, very consistent product, we know what we're getting and that's translating into better yields at the refinery, good throughputs. And so, as we go to wellhead and buy, we know the crude, the quality of the crude that's coming in, and another opportunity to leverage our expertise in our commercial business into our refining business.

We'll then talk about the East Coast and West Coast. So, when you think about 55% of our capacity in the Gulf Coast, is in the Mid Con, the real opportunity to put advantaged crude left to us is on our East Coast and West Coast.

So let me start on the East Coast at Bayway. We've built the 70,000 barrel a day rail rack. It's operational. We unloaded our first unit train in August, August 5. We can do one unit train a day there at Bayway. That was a global deal. We can do 50,000 to 75,000 a day in the global deal. And then we have our Jones Act vessels also to move crude around from the Texas Gulf Coast to Bayway.

Thinking about California, work in process, I would say, in terms of putting advantaged crude into California. Ferndale, we have a rail rack under construction, 30,000 barrels a day. It will be ready by the fourth quarter of this year. We're disappointed in the progress to permit our Santa Maria rail rack 40,000 a day, but we have – we're optimistic that we'll get that done. It just takes time in California to get these things permitted.

We signed a deal with Plains in Bakersfield to do 20,000 a day into that terminal. On the loading side, another 20,000 a day at Hardisty,10,000 a day at Cogen at Casper in Wyoming. So we're making progress in terms of put advantaged crude to the front of our refineries in California.

The thing I would say is in terms of North Dakota, we acquired 700 acres of land. We have permits in hand and engineering to construct a new rail loading facility. This is permitted up to 200,000 barrels a day. We'll probably do about a 160,000 barrels a day, about 300,000 barrels of storage there.

When you look at the rail fleet that we have, we acquired the first 2,000 cars. We said we're going to acquire another 1,200 and we're actually acquiring another 500 on top of that. So we're going to have 3,700 cars in total and we'll be able to move about a 185,000 barrels a day out of Bakken essentially East and West to these refineries. So we made a lot of progress in 2014 around putting advantaged crude both East and West.

Moving on and looking at the Gulf Coast, very important area for us. 33% of our capacity, refunding capacity is on the U.S. Gulf Coast. A large portion of our transportation assets are there. Well, I'll talk about the Beaumont Terminal acquisition on a subsequent slide. But certainly when you think about the crudes coming out of the Permian, the Eagle Ford and coming down from Cushing, the U.S. Gulf Coast is going to be an important place.

And logistics around the Gulf Coast are going to be important and an opportunity to create a lot of value. We currently have two Jones Act vessels that we use. Starting in January, we're adding a third Jones Act to the fleet. So we've added capability there coming up this January.

Working on expanding our dock capacity, we're about 440 today. Beaumont gives us 600,000 barrels a day of exports. We're up over 1 million barrels a day of export capability today and ultimately we get to one-one, one-two, so very important for our future.

The other thing I would say is that condensate, there's a lot of conversation around condensate today. Our definition is anything 45 or greater on API gravity and it could be anywhere from simple splitting to very complex splitters, but the infrastructure to gather then split and then the dock to export or to make the products go to the right markets with the highest value, we see a lot of opportunity around that. A lot of engineering work going on around infrastructure together, splitting et cetera, more to come on that in the future.

Talking about Beaumont, I will tell you we're really pleased with this asset. It's a great asset. It's in the right zip code. The employees we've got are just fantastic employees associated with this facility. 7 million barrels of storage capability, 5 crude, 2 million of products. We see the opportunity to expand this from 7 million barrels a day to 12 million barrels a day.

We see the ability to tie this into some of the pipelines that are getting built, that will show up in the Nederland area, and ultimately, part of our plan to make our Louisiana refineries look a lot more like a Texas refinery in terms of their access to crude and the ability to put more advantaged crude into our Louisiana refineries. So we think, it's a great asset. We didn't buy it exactly for what it is today but for what it can be. So we're excited about the opportunity that this terminal provides for us.

A word about Phillips 66 partners, we look at the PSXP as a tool and our toolbox is certainly a key vehicle that we're going to use to grow our midstream business faster. Without question, create significant value for the unitholders of PSXP but also for the shareholders of Phillips 66. Since the IPO just over a year ago, we've doubled the EBITDA at PSXP.

We've shown you the MLP math on the right, where there's $145 million of EBITDA embedded in PSX, was probably valued at about $1 billion and then, when we did this slide, it was about $6 billion of value. So clearly that incents us to keep our foot on the accelerator versus hitting the break in terms of the master limited partnership and how we use that master limited partnership.

The thing I would say is that until the MLP gets to scale, it does incent Phillips 66 to use our cash, to use our balance sheet, to build out the midstream and we're willing to do that, incubate projects at PSX and then drop those projects in to PSXP. So clearly, a big element of our growth profile and our capital spend is directed towards these kind of projects. But clearly pleased with the performance of PSXP at this point.

The other part of our midstream program is around DCP. DCP is our 50-50 joint venture with Spectra Energy. This joint venture has a 14-year history of creating value for its owners. DCP is one of the largest gas gatherers, processors, NGL producers, NGL pipeline operators in North America today.

We have an expectation, our plan is that the DCP EBITDA growth at 11% compounded growth rate, 2014, 2015 and 2016. Growth is being driven by – the big pipes are in service. We're ramping those up. But it's increased gathering capabilities, gas processing plants. DCP has about $2 billion of projects in flight and execution today between now and 2016, $4 billion to $6 billion worth of projects. Our view is that that DCP is on a self-funded basis, so they use their cash, their balance sheet and dropping assets into their MLP to fund this growth into the future.

So thinking about the chemicals portfolio, we own a half of a world-class chemical company. Chevron owns the other half at CPChem. Clearly, CPChem is a global company. We like the asset footprint that CPChem has. You look at their olefins and polyolefins business, about three quarters of it is in the U.S. and North America, about 25% in the Middle East. And those are the two best places to make petrochemicals today and what we think out into the next decade.

So we think the value capture opportunity is significant at our chemicals company. Over the next two years, growth is going to come from additions in 1-hexene, so that unit is operational, started up in June. And then, we're adding an additional furnace at Sweeny. But the real mover for CPChem is really the Gulf Coast petrochemicals project, which starts up in mid-2017, circa $6 billion project, adding 1.5 million tons of ethylene capacity and associated polyethylene capacity. Ethylene unit will be at Baytown. The derivatives, the polyethylene will be at our Sweeny complex.

So, I think as you work at the capacity increase, we got 36% O&P capacity increase, significant increase. And when you think about how does that translate into EBITDA, you can see – by the way, I should tell you, this is a look-through EBITDA. So, this includes the embedded D&A and interest and taxes of the joint ventures within CPChem themselves.

So, you can see $3.4 billion of EBITDA kind of on 2012 and 2013, good first half of the year this year. But we expect that these new projects as they come on, they get loaded up in 2017 increase the EBITDA by $1.3 billion to $1.6 billion on a price neutral basis for CPChem.

We will move on and talk about our refining business. Again, this business for us is run well, optimized business. We have 15 refineries or interest in 15 refineries, 11 in the U.S., 7 are coastal. Operating excellence is key. Putting advantaged crude to the front of refineries, working our yields, improving our yields at our refineries and working on our cost structure is the key of what we're trying to accomplish here.

$13 billion of capital employed in this business, it's a huge base. And when you think about 400 basis points of improvement in a business of this scale, that's huge. It's about $600 million of net income improvement. $400 million of that comes from advantaged crude capture, $200 million is around yields and cost reduction. So significant improvement in our base refining business. We view this as moving from a 10% to a 14% return on capital employed business.

A word about our specialties businesses in our marketing, so this is divided into U.S. marketing, our international marketing and then specialties. I think it's probably the first time we've shown you the pie chart. On average over the last five years, this is $1 billion of EBITDA in this segment.

You look at our U.S. marketing business, it's essentially a wholesale business, really around pull-through from the refineries. So you think about our inland refineries and think about our West Coast refineries, we think that pull-through is valuable today and we think it becomes more valuable in the future.

So you think about our European marketing, Central Europe, high return business, we have 1,200 sites. We're going to modestly grow this business over the next few years, add 200 sites between now and 2018. But again, selling under the Jet brand, high value, greater than 30% returns in this portion of the business.

Our specialties business consists of our finished lubes business. Our joint venture Excel Paralubes and base oil and then our specialty needle, anode-grade coke businesses. They're all very profitable. They all have high returns.

Our finished lubes business is the third largest in the U.S. It's a good return business. It's a business we want to grow selectively. The Spectrum acquisition was essentially a bolt-on acquisition. It increases our specialties EBITDA by about 10%. It really filled in some gaps that we had in our portfolio in terms of two cycle, four cycle. It filled in some international packaging gaps that we had. So just a nice bolt-on acquisition that we made. So it allowed us to extend our reach and to grow this business.

Okay, talk about capital allocation. I think at the April Analyst Meeting, we used this same slide and nothing's changed. As we said in April, as we consider cash from all sources, that could be funds from operations, it could be our balance sheet, it could be cash on hand, it could be cash generated from master limited partnership. 60% of that we're going to reinvest in the business. 40% of that we're going to distribute back to the owners of Phillips 66 Company in the form of dividends, secured growing, and then also share repurchases. So our view around that hasn't changed.

In terms of our distributions and dividends, the guidance we gave 2014, 2015, 2016, expect double-digit increases in the dividends. We think dividends need to be secure and growing and competitive. I think we're off to a good start this year in 2014, with a 28% increase in the dividend. And then, as long as the shares trade below intrinsic value, we're going to be buyers of our shares. And we think that creates value for the shareholders of Phillips 66 Company.

In terms of our capital structure, 20% to 30%, we're certainly at the low end of that. We wouldn't hesitate to go to our balance sheet to continue to fund a fairly aggressive growth program and also to fund our distributions. And, so let me kind of talk to that point if I can on this slide.

We said many times that mid cycle cash flow is between $4 billion and $5 billion for Phillips 66. And I know you guys like to do the math, and so if you start with a $1 billion dividend and $1 billion of sustaining capital and $3 billion of growth, that kind of get you to the $5 billion.

And one of the things that we want to make sure is that we completely feel comfortable that we have the capacity to execute a very aggressive capital program and a very aggressive distribution program. And that we have sources of cash, whether it's coming from funds of operations, whether it's coming from cash on hand, we have $5 billion cash on the balance sheet, $5 billion in capacity under the revolver. We have $4 billion to $5 billion capacity of debt and then we have billions of dollars of capacity with the MLP.

So, you think about that holistically. You think about our desire to grow our midstream business and incubate projects for the next two years to three years that ultimately are destined for the MLP. That's really the strategy. What I would say is that we're not going to jeopardize our balance sheet. We're not going to jeopardize our ability to continue to grow our distributions in terms of our dividend or it makes significant share repurchases over the next three years while we execute this strategy.

Talk about returns, we generally show you our returns versus our competitors and you can go back from [indiscernible] (26:25) through today, we're still leaders in our peer group in terms of returns. Every once in a while, I like to look at it this way. It reminds me of why we're investing in marketing and specialties and chemicals and in midstream.

You can see refining is 10% return. We do have a broad base of capital employed in our refining business, but clearly, as we shift the portfolio to higher returning, more stable, more highly valued businesses, that's where we're going to get the enterprise value enhancement at Philips 66. So, returns matter. We watch them and we watch them very closely.

Distributions, just an update on distributions. Between share repurchases and exchanges, we've taken in 66 million shares, kind of has a nice ring to it, doesn't it, 66, Phillips 66. It just kind of worked out that way. The dividend growth has been aggressive, 150%, we've gone from $0.20 to $0.50 a quarter in terms of the dividend.

In April, we kind of laid out what we wanted to accomplish in 2014. I know the year's not over yet, but we've accomplished most of what we wanted to accomplish this year. As you think about the growth $4.2 billion growth program, the acquisitions that we've made, we've doubled the EBITDA at the MLP level.

In terms of returns, we approved an advantaged crude capture from 91% to 93%. We've exported record volumes 180,000 barrels a day in the second quarter. So we're on track in terms of our return improvement. And then in terms of distributions, we've talked about 28% increase in dividend this year and additional $2 billion share repurchase. So $7 billion total authorized now, through the second quarter, $3.9 billion actually executed, so $3.1 billion to go under that authorization in that program.

So, when we think about Phillips 66 Company, we think it's a compelling investment story. Certainly, I think we're executing successfully of our strategy of growth, returns and distributions, set upon a strong foundation of operational excellence and having a high performing organization that knows how to win, and knows how to deliver differentiated value for our shareholders.

Given the uniqueness of our portfolio, we think that we offer investors a singular opportunity to participate in the value upgrade capture opportunity that North American energy is providing everyone. And so we are certainly all around that.

We have a leadership team that's experienced. They're experienced at managing commodity businesses, volatile businesses. They're experienced at mega project execution, and they're experienced at delivering operational excellence and provides personnel safety, process safety environmental excellence, reliability and cost management. So the blocking and tackling is there every day so that your investment is in safe hands with the Phillips 66 management team.

I would say that we do expect that we're going to see multiple expansion and that's going to translate into increased economic value or enterprise value for PSX shareholders. As we move our business to more stable, less volatile, more highly valued businesses, we expect that's going to show up in the share price for PSX. And then finally I'll just say that we're confident about the opportunity set that we have in front of us for Phillips 66 and our ability to execute on that.

So thank you for being here today, thank you for the interest in our company and I'll turn it back over to Paul.

Paul Cheng
Analyst, Barclays Capital, Inc.

Thank you, Greg. I think we have time for maybe one or two and mostly two questions and then we will move to the breakout session. There's a question here.

QUESTION AND ANSWER SECTION

Q

Greg, congratulations on the progress you've made since the spin.

Greg C. Garland
Chairman & Chief Executive Officer, Phillips 66

A

Thanks, [ph] George. (30:26)

Q

A quick comment, you're the only CEO that we've seen who emphasizes operational excellence throughout your presentation, so nice job on that. Quick question, what's your philosophy on major acquisitions either buying out your JV partners or a major acquisition in the midstream?

Greg C. Garland
Chairman & Chief Executive Officer, Phillips 66

A

So, I wouldn't rule out an acquisition. We've learned to say that. But as I evaluate the landscape and we look at the landscape every day, things look pretty fully valued to us in midstream and chemicals, where we want to make an acquisition and we look at the organic opportunities.

The issue with organic opportunity is it takes two years to three years before you start seeing and you have some execution risk on the organic, but certainly we think that we have a stable portfolio of opportunities to invest in, that we like and that we can create tremendous value for shareholders of PSX over the long-term.

So, we do look at that universe. I would say that we're never going to overpay for anything. I mean, buy high, sell low is a terrible strategy and a lot of people get caught up in that over the course of their careers, but I guess I'd tell you, we don't need to do that. And we're blessed in many ways and I'm thankful in many ways that we have this large organic portfolio in front of us that we have to invest in.

Operational excellence is critical. As you know, we have a legacy of great performance there. We think about it every day, and I would just tell you, I am convinced that we protect and we enhance shareholder value by getting that part of our jobs right every day.

Paul Cheng
Analyst, Barclays Capital, Inc.

Thank you, Greg. I think we will move to the breakout session for additional Q&A. Thank you. It's going to on the Liberty 3.

Greg C. Garland
Chairman & Chief Executive Officer, Phillips 66

Great, thank you.