TRANSCRIPT

2Q 2018 EARNINGS CONFERENCE CALL

PHILLIPS 66 (NYSE: PSX)

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PHILLIPS 66 PARTICIPANTS

Jeff Dietert, *Vice President, Investor Relations*

Greg C. Garland, *Chairman and Chief Executive Officer*

Kevin J. Mitchell, *Executive Vice President and Chief Financial Officer*

MEETING PARTICIPANTS

Neil Mehta, *Goldman Sachs*

Roger Read, *Wells Fargo Securities*

Phil Gresh, *JP Morgan*

Paul Cheng, *Barclays Capital*

Justin Jenkins, *Raymond James & Associates, Inc.*

Doug Leggate, *Bank of America Merrill Lynch*

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Meena Gupta, *Credit Suisse*

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Craig Shere, *Tuohy Brothers*

TRANSCRIPT

Operator:

Welcome to the Second Quarter 2018 Phillips 66 Earnings Conference Call. My name is Julie and I will be your Operator for today's call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded.

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

Jeff Dietert:

Good morning and welcome to Phillips 66 Second Quarter Earnings Conference Call. Participants on today's call will include Greg Garland, Chairman and CEO, and Kevin Mitchell, Executive Vice President and CFO. The presentation materials we will be using during the call today 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. It is a reminder that we will be making forward-looking statements during the presentation and our Q&A session. Actual results may differ materially from today's comments. Factors that could cause actual results to differ are included here, as well as in our SEC filings.

With that, I'll turn the call over to Greg Garland for opening remarks.

Greg C. Garland:

Okay. Thanks, Jeff. Good morning, everyone, and thank you for joining us today. Our diversified businesses operated well and delivered strong earnings and cash flows. Adjusted earnings were $1.3 billion, or $2.80 per share. Refining had one of its best quarters and ran at 100% capacity utilization, capturing strong margins. Our refining system has industry-leading coking capacity which allowed us to benefit from continued favorable heavy crude differentials.

We generated $2.4 billion of cash from operations during the quarter, which is the highest since 2012. We rewarded our shareholders by returning $602 million through dividends and share repurchases, which brings our total distribution for the year to $4.4 billion. A secure, competitive, and growing dividend is fundamental to our strategy.

During the second quarter we increased the dividend 14%, resulting in a 27% compound annual growth rate since 2012.

We're executing our long-term strategy to capture growth opportunities and enhance returns. Our Midstream organization is moving forward with two major growth projects: construction of the Gray Oak Pipeline and expansion of the Sweeny Hub. Phillip 66 Partners recently completed the expansion open season for the Gray Oak Pipeline. Gray Oak will provide crude oil transportation from the Permian in Eagle Ford to Texas Gulf Coast destinations, including our Sweeny Refinery. The pipeline will have an initial capacity of 800,000 barrels per day based upon shipper commitments of 700,000 barrels per day and a reservation of walk-up capacity for shippers. Gray Oak is expandable to approximately 1 million barrels per day and expected to be in service by the end of 2019. Total cost for the project is anticipated to be approximately $2 billion. Phillips 66 Partners will be the largest equity owner in this joint venture project.

At Sweeny we are building two 150,000 barrel-per-day NGL fractionators and adding 6 million barrels of storage at Phillips 66 Partners' Clemens Caverns. We have agreements in place with multiple parties, including DCP Midstream, to supply the new fractionators. The Hub will have 400,000 barrels a day of fractionation capacity and access to 15 million barrels of storage when expansion is complete in late 2020.

We expect robust NGL value chain fundamentals, including continued production growth in the Permian and other shale plays. Our Sweeny Hub is strategically located on the Texas Gulf Coast. The hub includes NGL fractionation and storage capacity with access to local petrochemicals and fuel markets, and 200,000 barrels a day of LPG export capacity. Both the Freeport Export Terminal and our Sweeny Fractionator continue to exceed design rates.

At our Beaumont Terminal we recently placed 1.3 million barrels of fully contracted crude storage into service, bringing the terminal's total crude and product storage capacity to 12.4 million barrels. Additional crude oil tanks are under construction that will increase the terminal's capacity to 14.6 million barrels by the end of the year. We expect the continued growth in domestic crude production will result in higher Gulf Coast exports, and our Beaumont Terminal is well positioned to capitalize on this growth.

DCP Midstream continues to expand the Sand Hills Pipeline to meet the demand from the growing NGL production in the Permian Basin. During the second quarter, DCP increased the pipeline's capacity to 425,000 barrels per day with further growth to 485,000 barrels per day by the end of this year. Our new Sweeny fractionators will be supplied by Sand Hills. This pipeline is owned two-thirds by DCP and one-third by Philips 66 Partners.

Also in the Permian Basin, DCP Midstream has a 25% interest in the Gulf Coast Express Pipeline project, which will transport 2 billion cubic feet per day of natural gas to Gulf Coast markets. Completion of the pipeline is anticipated in the fourth quarter of 2019.

In the high-growth DJ Basin, DCP's Mewbourn 3 gas processing plant is expected to start up in the third quarter of 2018 and the O'Connor 2 plant in the second quarter of 2019.

In Chemicals, CPChem has strong operations from its new Gulf Coast petrochemicals assets, which contributed solid earnings growth during the quarter. Ethane crackers demonstrated 3.5 billion pounds per year of capacity, which is 6% above the original design rates.

In Refining, we've approved an FCC optimization project at our Sweeny Refinery that will increase production of higher-valued petrochemical products, as well as higher octane gasoline. This project is anticipated to complete in mid-2020.

We've completed FCC monetization projects at the Bayway and Wood River refineries. At both facilities, we upgraded FCC reactor with state-of-the-art technology. The units are performing as expected and are yielding higher value clean products.

With that I'll turn the call over to Kevin to review the financials.

Kevin J. Mitchell:

Thank you, Greg. Good morning. Starting with an overview on Slide 4, second quarter earnings were $1.3 billion. We had special items that netted to a gain of $17 million. After excluding special items, adjusted earnings were $1.3 billion or $2.80 per share. The second quarter adjusted effective tax rate was 22%.

Operating cash flow was $2.4 billion. This included distributions from equity affiliates of $610 million and positive working capital impacts. Capital spending for the quarter was $538 million with $348 million spent on growth projects. Second quarter distributions to shareholders consisted of $372 million in dividends and $230 million in share repurchases. We ended the quarter with 464 million shares outstanding.

Slide 5 compares second quarter and first quarter adjusted earnings by segment. Quarter-over-quarter adjusted earnings increased over $800 million, mainly driven by refining.

Slide 6 shows our Midstream results. Transportation adjusted net income for the quarter was $137 million, in line with the previous quarter. Increased volumes following the completion of first quarter refinery turnarounds and higher Bakken Pipeline equity earnings were offset by asset impairments and seasonal maintenance. NGL and other adjusted net income was $50 million, down $23 million, reflecting positive inventory impacts in the first quarter of about $20 million.

We continue to run well at the Sweeny Hub. During the quarter, the export facility averaged 10.5 cargoes a month and the fractionator averaged 109% utilization. While improved, U.S. Gulf Coast to Asia LPG export margins remain challenged.

DCP Midstream had adjusted net income of $15 million in the second quarter, a $9 million decrease from the previous quarter. The first quarter included a $9 million benefit due to timing of incentive distributions. The impact from increased volumes during the quarter was offset by seasonal operating and maintenance costs.

Turning to Chemicals on Slide 7, second quarter adjusted net income for the segment was $262 million, $30 million higher than the first quarter. In Olefins and Polyolefins, adjusted net income increased $23 million from the ramp-up of the new ethane cracker and polyethylene units. Global O&P utilization was 95% in the second quarter. Adjusted net income for SA&S increased $14 million from the completion of first quarter turnarounds. CPChem's other adjusted net costs increased due to lower capitalized interest following completion of the U.S. Gulf Coast petrochemicals project.

Next on Slide 8 we will cover Refining. Crude utilization was 100% compared with 89% in the first quarter. Our second quarter clean product yield was 84%. Pretax turnaround costs were $60 million, a decrease of $185 million from the previous quarter. Refining second quarter adjusted net income was $911 million, up $822 million from last quarter. Across our regions, the increased earnings were due to higher realized margins as well as higher volumes and lower costs following the completion of first quarter turnarounds. WRB equity earnings also increased this quarter due to the completion of turnarounds at the Wood River and Borger refineries.

The market crack increased 13% during the quarter. Our realized margin improved 32% to $12.28 per barrel, up from $9.29 per barrel last quarter. The increased margin capture was primarily due to the widening Brent-WTI spread, discounts on U.S. inland crudes, and approved heavy crude differentials. Capitalizing on our integrated infrastructure and supply network, we sourced more advantaged crudes into our refining system in response to widening differentials.

Slide 9 covers market capture. The 3:2:1 market crack for the second quarter was $14.86 per barrel compared to $13.12 per barrel in the first quarter. Our realized margin for the second quarter was $12.28 per barrel, resulting in an overall market capture of 83%, up from 71% in the first quarter. Market capture was impacted in part by the configuration of our refineries. We made less gasoline and more distillate than premised in the 3:2:1 market crack.

Losses from secondary products of $2.81 per barrel were higher than the previous quarter by $1.34, primarily due to rising crude prices. Feedstock improved realized margins by $3.15 per barrel, which was $1.52 per barrel better than the prior quarter due to improved crude differentials. The other category mainly includes costs associated with product differentials, RINs, outgoing freight, and inventory impacts. This category reduced realized margins by $0.75 per barrel compared with $2.08 per barrel in the prior quarter. The improvement was driven by lower RINs costs and improved clean product realizations.

Let's move to Marketing and Specialties on Slide 10. Adjusted second quarter net income was $195 million, $21 million higher than the first quarter. In Marketing and Other, seasonally higher volumes and improved West Coast and Central region margins contributed to increased earnings. We re-imaged over 250 domestic marketing sites during the quarter, bringing the total to over 1,700 since the start of the program. We continue to see strong export demand during the quarter with 200,000 barrels per day of refined product exports. Specialties adjusted net income increased $5 million from improved base oil margins.

On Slide 11 the Corporate and Other segment had adjusted net costs of $183 million this quarter, compared with $162 million in the prior quarter. The $21 million increase reflects higher interest expense and taxes.

Slide 12 highlights the change in cash during the quarter. We entered the quarter with $842 million in cash on our balance sheet. Cash from operations, excluding the impact of working capital, was $1.7 billion. Working capital changes increased cash flow by $692 million, primarily from increased net payables as refining returned to normal operating levels following the first quarter turnarounds. During the quarter we funded $538 million of capital expenditures and investments, returned $602 million to shareholders through dividends and the repurchase of shares, and repaid $250 million of debt. Our ending cash balance was $1.9 billion.

This concludes my review of the financial and operational results. Next, I'll cover a few outlook items for the third quarter. In Chemicals, we expect the global O&P utilization rate to be in the mid-90s. This reflects the Cedar Bayou ethane cracker at the recently increased capacity of 3.5 billion pounds per year. In Refining, we expect the worldwide crude utilization rate to be in the mid-90s and pretax turnaround expenses to be between $60 million and $80 million. We anticipate Corporate and Other costs to come in between $170 million and $190 million after tax.

With that, we'll now open the line for questions.

Operator:

Thank you. We will now begin the question-and-answer session. If you have a question, please press star, then one on your touchtone phone. If you wish to be removed from the queue, please press the pound key. If you are using a speakerphone, you may need to pick up the handset first before pressing the numbers. Once again, if you have a question, please press star, then one on your touchtone phone.

Neil Mehta from Goldman Sachs, please go ahead. Your line is open.

Neil Mehta:

Hey, thanks very much, guys.

Greg C. Garland:

Good morning.

Neil Mehta:

Good morning, Jeff. Good morning, Greg and Kevin. I appreciate the comments today and congrats on a good quarter. I want to talk a little bit about the captures because they certainly came in better than what we expected on the Refining segment, and could you just help us understand what drove the delta versus maybe what you guys were even modeling internally? And I suspect part of it has to do with the way we are modeling the crude capture versus the product capture, if that makes sense; you just have a tendency to have more of the crude discounts drop to the pretax margin. But just any of those deltas would be helpful in terms of framing the go-forward.

Jeff Dietert:

Yeah. I think Refining performed exceptionally well in the quarter, averaging 100% utilization, so I think the most important thing is we were up and running well in a strong margin environment. Turnaround expenses were down substantially quarter-on-quarter and that brought down operating costs, it increased volumes, and helped improved yield. We also took advantage, through our integrated supply network, to capture crudes. We benefited from the wide WTI-Brent differential. We benefited from inland crudes trading at steeper discounts, including Canadian heavy, Bakken and Permian crudes, as well as improved heavy discounts on the Gulf Coast and on the West Coast as well.

We also saw some improvement in product price realizations, especially on the Gulf Coast and in the West Coast as well. I think, finally, RINs costs were cut in half during the quarter, so that helped capture rates as well.

Neil Mehta:

That's helpful color. I wanted to build on that WCS point because we've seen the differentials really widen out here; you guys import more WCS than anybody else. Could you just kind of talk about how you see that playing out through the balance of this year and into 2019, ahead of Enbridge Line 3 and before the IMO impact?

Jeff Dietert:

Sure. We had the Syncrude outage this summer, which supported WCS temporarily, but now that project is starting to come back on. We expect additional volumes in August and September. Fort Hills is continuing with its impressive ramp towards 200,000 barrels a day, potentially higher. As we look at maintenance activity, PADD 2 has well above average refinery maintenance planned for the fall, and some of that is going to reduce the demand for WCS as well. We see a seasonal opening of WCS discounts this fall. We expect the discount to be set by rail, assuming there is sufficient rail capacity, which would be the equivalent of kind of WTI minus 20. If rail is not sufficient, it could be wider. When you look at the Canadian exports by rail, we did see a new high in April, 190,000 barrels a day, but that's only slightly higher than the average of 130,000 barrels a day last year, so we're getting a little bit more rail but not substantially more. We expect WCS discounts to be attractive for at least the next 18 months and potentially longer.

Neil Mehta:

Thanks, Jeff.

Operator:

Roger Read from Wells Fargo, please go ahead. Your line is open.

Roger Read:

Yeah. Thank you. Good morning, and really, really great quarter there, I think we have to say. I'd like to come at it from the Refining utilization side; 100% utilization and we've seen from the DOE stats really good performance for the whole industry. I was just curious; is this a function of that really is utilization or maybe there's been some increases in capacity that aren't exactly being measured properly, not so much for you but maybe for the industry? Then, how should we think about running above utilization levels as we roll into an IMO-driven event next year?

Greg C. Garland:

Well, in our case, Roger, certainly we came out of a heavy turnaround in the first quarter. We came up. We ran really well. Given the market opportunities available to us, I think we had an opportunity to run. I suspect that we are in a period where diffs may come in just a little bit, but then as we come back into the maintenance season in the fall, you're going you see those diffs open back up in many cases. IMO is going to be a nice tailwind, I think, for the industry as we start moving into 2019, particularly the back half of 2019. I think that we're pretty constructive on both the supply and demand side. We've got a strong economy going and you know, you think about the opportunities that come in, in '19, we're pretty constructive on that. I don't know, Jeff, if you want to add any color on the IMO.

Jeff Dietert:

No. I think that's all accurate. I think the IMO is going to benefit complex refining and so I would expect higher utilization of the complex refineries in the U.S., and in our portfolio, higher utilization of coking capacity, which we are an industry leader there. I think there will continue to be a focus on running well, certainly within our portfolio.

Roger Read:

Yeah. Appreciate that. I guess that's what I'm trying to get that is if you ran at 100% this quarter, and the anticipation is that margins would be even more favorable in the latter part of '19 into '20. I mean, do we think about this as you can run at 102 or 103 or something like that? Or is there something else that we should be focused on, like this kind of is it and so you just have to simply work your way within the system as is?

Greg C. Garland:

Well, just a couple of points. I think that even in our second quarter, we're probably at about 3.5% downtime due to unplanned downtime and turnaround activity during the quarter, so obviously we had assets that ran well above the 100% level coming into it. The other thing I would say, we've come through two heavy turnaround years in '18 and '17 for us, and so we're really, I think from a portfolio standpoint, turnaround standpoint, well positioned for '19 and '20 to run well.

Roger Read:

I appreciate that. And then as you look at secondary impacts of the IMO here potential for some of the weaker competitors out there really outside the U.S. to get pushed out, any thoughts about how that will affect crude flows or product demand?

Jeff Dietert:

Well, I think the refineries that produced high percentage of fuel oil are going to be the ones that are going to be stressed. You know, a lot of Latin American refineries fall in that category. We'll have to see how the product flows adjust, but we're focused on our portfolio and making sure we can meet the standards across all our refineries.

Roger Read:

Okay. I appreciate it. Thank you.

Operator:

Phil Gresh from JP Morgan, please go ahead. Your line is open.

Phil Gresh:

Hey, good afternoon. Good morning. First question is on Chemicals; could you just elaborate a little bit about what kind of contribution you think you saw from the cracker in the second quarter? What kind of startup costs may have still been incurring, and just kind of trying to tie it back to your mid-cycle guidance, kind of adjusted on a quarterly run rate basis; if you have anything on that?

Kevin J. Mitchell:

Yeah, Phil. It's Kevin. I'd say as you look at the second quarter you certainly have some ramp-up in terms of utilization, so you don't have a complete quarter of contribution from those assets, although by the end of the quarter we were at very healthy utilization rates. I don't think startup expenses were anything to really move the needle in the quarter; they may have been a little bit, but it's just not material. I think as we step back and look at this, the mid-cycle guidance that we've talked to previously is still intact, so still expect to generate that incremental EBITDA in the same range of numbers we've talked about in the past.

Greg C. Garland:

Yeah. I think, moving in the third quarter, we certainly would expect the kind of run rate type levels and performance out of that asset. You think about the near-term, so Dow was up, we're up now, Exxon Mobil is coming up, and so, near-term, you could have some compression of margins as these volumes just start to get absorbed in the marketplace; offsetting that though, the global economy is strong, you saw the GDP number for the U.S. today, and so we've got great demand on this and so we're still pretty constructive, you know, out over the next three to four years of good, solid demand growth and I think that our view is that there's probably more upside to downside on the margins if you want to look out in kind of this three- to four-year window.

Phil Gresh:

Greg, If I were to think about how that feeds into your timing of a potential second cracker, what are your latest thoughts there?

Greg C. Garland:

Well, I think you kind of start with the fundamentals. You still have 500,000, 600,000 barrels a day of ethane rejection; there's more coming at us. There's going to be plenty of feedstock for the next wave, so to speak, of crackers. We're funding work on the second cracker today. I think the FID decision is one we obviously haven't taken yet, Phil, but I think that probably late '19, '20 is still what we are thinking in terms of FID for the next cracker. We, frankly, like that spacing in between this project and the next project.

Phil Gresh:

Okay. And then, Kevin, just on the cash flow and the cash balances and the allocation of that, and I know you've talked about wanting to pay some of the debt down that you incurred in the first quarter. Obviously, you've got some of the working capital reversal on the cash balances built up nicely, so how do you think about the cash balances now and what you want to prioritize for the rest of the year?

Kevin J. Mitchell:

Yes. So, $1.9 billion at the end of the second quarter, obviously the first quarter not only impacted by the normal working capital drain that we see in 1Q but with the Berkshire buyback, we drained cash to partly fund that as well, so getting cash back to a more comfortable range for us. I think you'll see, to the extent we continue to have strong cash generation, we will probably do a bit more debt paydown. Debt's probably running a little bit higher than we'd like it to be. I mean, the balance sheet is still strong, still get great credit ratings, but we'd like to do a little bit more on buybacks, sorry, debt paydown.

Greg C. Garland:

We need some more buybacks too, so it's okay.

Kevin J. Mitchell:

That right there is a possibility. And then, we've talked about the growth projects and the capital programs. We may end up building a little bit more cash. I think we're still—if you look where we've been over the last four or five years or so, we had been running cash that's been $2 billion to $3 billion, certainly, for a chunk of our time, so it wouldn't surprise me if we end up carrying a little bit more cash for a period of time.

Phil Gresh:

Got it. Okay. Thank you.

Operator:

Paul Cheng from Barclays, please go ahead. Your line is open.

Paul Cheng:

Hey, guys. Good morning.

Jeff Dietert:

Hey, Paul.

Paul Cheng:

Very good quarter.

Jeff Dietert:

Thank you.

Paul Cheng:

Maybe then, Greg, just curious then; in the Refining in this quarter, if we have a similar market condition, do you think that is repeatable for your performance or do you think that this is heavy or stars are just not right for you guys and would be difficult for to repeat it?

Greg C. Garland:

Well, you know, I think that we are set up to run well in terms of utilization. We don't have a lot of big turnarounds in front of us coming into the third quarter from that standpoint. I think that definitely the market plays to the strength of our portfolio. You know I think our commercial and supply folks did a really nice job getting the right crudes to the front of refineries and then the guys in refineries did a great job of running those crudes and creating value. But as I look out into third quarter or fourth quarter, I'm still constructive on refining kind of going forward. Whether we can repeat a $1.3 billion quarter or not, I can't forecast that for you today, but I do think that refining is going to do well coming into the third quarter.

Paul Cheng:

It seems the margin, near-term bottom in late June, they are recovering. In the last several days, I have seen a certain surge. Just curious, have you guys seen any theory behind why the last several days we see such a strong movement in the bottom margins?

Jeff Dietert:

You know, I think it's mainly driven by utilization. We saw very strong utilization early in the summer and in June, and that drove gasoline prices down into the quarter, relatively soft in 2Q. Since that time, we've seen utilization come down. Demand's remained relatively healthy on the gasoline side and now gasoline cracks are back up to the middle or slightly above the five-year range. On the diesel side, we're seeing really strong demand, 9% up year-on-year, and that's driven by strong trucking activity with 8% increase year-on-year; rail movements are up 3.7% year-on-year; and we're seeing strength in the areas where oil drilling activity is ongoing as well. And the distillate inventories are at the low end or actually below the five-year range on absolute and days of demand cover basis, so distillate looks really strong.

Paul Cheng:

Yes. Thank you. I mean, all those are great information. I'm just curious because typically those are not going to need all this stuff then for the last several days and then jump, so wondering if your marketing people have seen any news or anything out there saying what all of a sudden happened in the last several days that may have triggered such a substantial move.

Jeff Dietert:

There's been some unplanned downtime, some heat-related power issues, but nothing more broad, more specific than that.

Paul Cheng:

Can you tell us how much is the heavy oil you run in the U.S. in the second quarter comparing to the first quarter or the second quarter last year as a percentage?

Jeff Dietert:

It was up slightly. I don't have that off the top of my head, but I'd be happy to get back with you.

Paul Cheng:

Okay. And for capex, for Kevin, the previous range that you guys had given, is this still a good range even if we assume that you're going to make more money and have more cash?

Kevin J. Mitchell:

The capex, Paul?

Paul Cheng:

Yes.

Kevin J. Mitchell:

Yeah. As you know, we've just recently sanctioned two large Midstream projects at a consolidated level, obviously Gray Oak Pipeline being done at the MLP, but that rolls up under the consolidated number. Year-to-date spend is running lower, so just under $900 million year-to-date; the consolidated budget is $2.3 billion. But we are seeing the spend rate pick up and we would expect that to continue into the second half of the year, so at this point, I'd say there's potential that we could go a little bit over the $2.3 billion budget in aggregate. I don't think it would be significantly above that. I mean, I would guess at this point we'd be somewhere between $2.3 billion and $2.5 billion for the year. Obviously, as the next few months go by, we'll have much better visibility into where that's going to end up.

Paul Cheng:

How about the next several years, Kevin; should we still assume about $2.5 billion range or it's going to be higher?

Kevin J. Mitchell:

Yeah, I would. I think in overall terms the $2 billion to $3 billion a year of capex is good guidance to go with, Paul.

Paul Cheng:

Two final questions; a quick one: do you guys think that we will have sufficient crude export capability in the Gulf Coast, say, over the next two or three years, we will continue to increase the warning that we need to explore by 500,000 to 1 million barrels per day a year; and whether that is a business you guys also want to get into more? And secondly, when you contact with your government people, do you think that there's a high risk that IMO 2020 ends up being pushed out because of potential backlash? What do you expect in terms of the record rising, the product prices come to materialize?

Jeff Dietert:

All right. Yes. Paul, I would say we do see a big opportunity for exports across oil and products. As part of the Gray Oak expansion, we've got the South Texas Gateway and as we look at the majority of the large long-haul pipelines, they have got export options and so we see export capability being added. We believe most of the incremental production is going to get exported and so we do see that opportunity and see the market addressing it.

With regard to IMO, we are gaining confidence in the implementation date. The IMO certainly is emphasizing moving forward. When you look at the other fuels have already reduced sulfur, and bunker fuel is a small percentage of total transport demand, but it makes up the vast majority of SO2 emissions, and so I think there's incentive to move forward. We see a recent announcement out of China announcing that they are going to increase their marine fuel regulations to require the 0.5% sulfur next year and then taking it down 0.1% sulfur in the following year. We've seen the IMO focus on inspections on both import and export facilities, and so we see this moving forward on 1/1/2020. There may be, or we would expect that there would be, a system set up in the event that supply is not available on a one-off basis, that there may be a waiver, but it would be short-term in nature and specific to particular incidents.

Paul Cheng:

Thank you.

Greg C. Garland:

Thanks, Paul.

Operator:

Justin Jenkins from Raymond James, please go ahead. Your line is open.

Justin Jenkins:

Great. Thanks. Good morning, everybody. I guess maybe starting in the Permian—appreciate all the additional details on the Gray Oak project, but is it right to think that the scope of that project is being designed, that it can be taken all the way to the million-a-day number with pretty little incremental capital from the 800,000 a day starting point?

Greg C. Garland:

Well, we put in 30-inch pipe, so that kind of tells you that it's going to be a pretty easy lift to get to the million barrels a day. So, yeah, I think that there's a lot of interest still in the Permian and takeaway capacity. I think we're pleased with where we'are at in terms of project execution. You've got the steel on order essentially lined up with the contractors and so the project is really on track. So, we're pleased with where we're at.

Justin Jenkins:

Perfect. Appreciate that. Then maybe following up on Phil's question on capital allocation, how should we think about M&A, if at all, in that process, maybe especially with some of the Midstream packages out there today?

Greg C. Garland:

Well, I think, you know, we, like everyone else, kind of looks at everything that's out there. Things still look really pricey to us, particularly in the Midstream space. As you think about the opportunity to create value, we have such a great organic profile in front of us that we don't feel like we need to rush out and do something in terms of the M&A space today. We'll continue to watch it. If we can create value by doing it, we're certainly willing to do it. We've got the balance sheet and the capability to do it if the right opportunity happens to come our way.

Justin Jenkins:

Great. Thanks, Greg. I appreciate it.

Operator:

Doug Leggate from Back of America Merrill Lynch, please go ahead. Your line is open.

Doug Leggate:

Thanks. Good morning, everybody. Kevin, maybe if I could go back to the cash question; you've got a nice distribution obviously from CPChem this quarter. I'm just curious, as a kind of broad idea of how this might evolve, is that a biannual distribution? How do you expect that to look going forward and is there a level of cash that you want to get back to? I think you kind of suggested you obviously want to build a little bit more cash after the Berkshire buyback and so on. Is there a level of cash you want to get to and, I guess, as a bolt-on to that, did the balance between share buybacks and dividends - latest thoughts? And I've got a quick macro follow-up, please.

Kevin J. Mitchell:

Okay. In terms of absolute cash level, I'd say there's not a target level, there's not a number. Very comfortable with where we are today, so I think of when we were $800 million at the end of the first quarter, that's a bit lower than we like to be. You're probably looking at something north of $1.5 billion-plus, $1.5 billion to $3 billion is a very comfortable range to be in, but not targeting any one particular number on that.

In terms of CPChem cash distributions, there is no set schedule on distributions. So, we've guided to $600 million to $800 million this year. It's a significant increase from where we have been and it's driven by a function of higher operating cash flow with the new assets coming online, as well as much lower capital spending at the CPChem level. Now, ideally, a quarterly distribution would be perfect, but it doesn't necessarily play out like that., so it's somewhat dependent on how the cash balances at CPChem move over month-to-month, and as a Board we kind of work through what the appropriate distributions are going to be, so ratable would be nice, and it probably will be not too far off of ratable, but it can still be somewhat lumpy there.

Now, there was a third one.

Greg C. Garland:

Can I just come in on that, just a little bit?

Kevin J. Mitchell:

Yes.

Greg C. Garland:

The Board can decide what to do at CPChem, but the basis of the foundation agreements are is we really don't hold a lot of cash at CPChem; we tend to distribute the cash out. Obviously, we want to hold enough cash to do the capital programs or whatever is going on at CPChem, but as kind of a basic fundamental tenant to the joint venture, we tend to distribute the cash.

Doug Leggate:

Okay. Thanks, Greg. Sorry, Kevin; the last one embedded in there was any change in the thoughts of buyback dividend balance?

Kevin J. Mitchell:

Really not. The principles around the dividend: secure, growing, competitive, and obviously you saw the 14% increase last quarter. Then buybacks, we look at that on an intrinsic value. We look at where the shares are trading relative to our view of intrinsic value. We've guided to a $1 billion to $2 billion range in normal circumstances; obviously this year is a little bit unique with the large transaction we did last quarter. But in overall terms, no change.

Doug Leggate:

Thanks. Greg, I wonder if I could just go to my macro question then. I've kind of got two parts to it, if I may. On IMO, obviously you've been—I think if I may phrase it this way—a little more measured in your expectations on how that may play out in the way you characterized it. But we're starting to hear about dormant refineries coming back up. [Several have] been mentioned, I think there's a German refinery that's one to be mentioned. I'm just curious as to how you could frame your thoughts as to how much conviction you have on the scale of the potential benefit.

My quick bolt-on is to one of the earlier questions on the export issue. It's a bit of a random one, really, but are we comfortable if the export capacity gets built; the bottleneck gets cleared once the pipelines move, and assuming there's no trade war ramifications from the potential outlets there. I'll leave it there. Thanks.

Greg C. Garland:

I think that we'll go backwards with it. The export capacity is going to get built. I think the infrastructure to clear all the products, whether it's crude, NGLs, or gas, are going to get built because it just looks like, to us, that the production is going to grow faster than what we can consume it here in the U.S. I think that fundamental premise that we're going to be exporting all three products is a good one, and we actually want to participate in that. We talked about the Buckeye, but we're also, by the end of the year, we're going to have Beaumont going from 600,000 to 900,000 barrels a day. If you think about kind of our export platforms off the U.S. Gulf Coast, we've probably got 10% or 12% expansion capabilities laid into those over the next two years or so. So, I think we're trying to position the portfolio to get ready to export more crude and products.

Then on IMO, I suspect that people—and we're familiar with the German one you just mentioned; we shut it down.

Doug Leggate:

Yes. That's right. You can probably speak to the speculation. It was probably the equity who was speculating. You're not selling it then.

Greg C. Garland:

No. We're happy with our position there, Doug. Let's put it like that. But, no; I think IMO is kind of perceived as a big opportunity to by people and people are going to try to play that opportunity to the extent that they can. I think that, fundamentally, our view hasn't changed. I think that over the next, say, couple of years that it's going to be a nice tailwind for the industry. I mean, we can argue about where there's $5 or $10 on the distillate crack or what it's going to be, but, you know, I do think when you look out over a long enough timeframe, we will continue to build global refining capacity and that capacity will get directed to solve that problem. A lot of that capacity is going to go up in the Middle East and in China and India.

I just think that over time that the industry will work its way through this and, indeed, that's been the history of the industry over a long period of time is that the big opportunities tend to get competed away over time. I just don't fundamentally have a different view on that today.

Doug Leggate:

Just last bolt-on very quickly. I mean, all you guys have endured—it was the same with Valero and [Marathon Petroleum] have been relatively constructive in the second half. Are you factoring in the announcement for Mexico that their entire refinery system could go down for maintenance in the second half of the year, in your thoughts?

Greg C. Garland:

I just saw that. That certainly is a nice tailwind.

Jeff Dietert:

Yeah. It could be a meaningful impact next year, an ongoing trend to the Venezuela refining utilization and Mexico refining utilization. You know, as we think about IMO, it will likely take some time. There's not a substantial uptick in capital spending that's underway to meet the IMO specs and these are projects that are capital intensive and long lead time. The high complexity refineries, many of them are running at high utilization rates already, so I think it will be a challenge for the industry, but a challenge we're up for.

Doug Leggate:

Thanks, everybody. Appreciate your answers.

Greg C. Garland:

Take care.

Operator:

Brad Heffern with RBC Capital Markets, please go ahead. Your line is open.

Brad Heffern:

Hey, good morning, everyone.

Greg C. Garland:

Hey, Brad.

Brad Heffern:

Question on the cracker. So, you guys have already demonstrated above nameplate on that. I'm sure that you are not very far along in the de-bottlenecking process either. Any thoughts as to where that could go over time if you've already demonstrated such healthy level?

Greg C. Garland:

Well, I think that with all assets, we'll get better as we get more experience running it. We know that we have some probably low-cost cap to de-bottleneck in that facility too that I think we will be able to address better with you in the coming quarters. But, certainly, the asset came up and ran better than our expectations and, I think, probably the smoothest startup we've seen in the last five of those big assets that we started up.

Brad Heffern:

Okay. Great. And then, on the new fracs, you guys obviously put out a cost estimate, but no EBITDA number. I would think that the fracs themselves are probably getting sort of a normal tolling fee, if you will, but I know you overbuilt the original one, so I would imagine the whole system should work better together. So, any thoughts on what the EBITDA uplift across the whole hub is?

Greg C. Garland:

Well, on the new fracs themselves, you should expect kind of typical tight midstream returns, and so let's call it 6x to 8x, and the fracs are probably to the higher end of that, the pipes are probably to the lower end of that. You could kind of back into it.

Brad Heffern:

Okay. But is there any uplift for the existing assets from having the two new fracs installed?

Greg C. Garland:

Yeah. There's no question that a large part of the investment for Frac 1 was an infrastructure, pipes to get to Belvieu and back. Some of the early Cavern work that we did today off of Frac 1, we're making, I don't know, 38,000 barrels a day of propane and we're running to export facility at 200,000 barrels a day. And so that delta between what we are making and what we're exporting, we're actually bringing from Mount Belvieu and so we're buying those barrels in Bellevue today and we're paying a fee to move them on the pipes. There are going to be synergies and uplifts by making more of the propane at the Sweeny site to be exported.

Brad Heffern:

Okay. Thank you.

Greg C. Garland:

You bet.

Operator:

Manav Gupta from Credit Suisse, please go ahead. Your line is open.

Manav Gupta:

Hey, guys. Looking at the ethylene cracker startup over the last decade, all the crackers that came online in Middle East between '09 and '12 had some startup issues. One of your peers received mechanical completion in 1Q, could not start the cracker for six months and then ran into multiple issues at the startup. The other crackers had one of the smoothest starts we have witnessed in the last decade. Most ethylene crackers achieved 70% to 80% design rate; you're already hitting 90% so it's pretty impressive. I'm just trying to understand how you did it, like what did you guys do so differently that others could not, and what's the trend?

Greg C. Garland:

Well, hopefully we learned something over the five times when we were one of those parties that started up and had trouble in the Middle East. I think our last outing was our Saudi Polymers project and it took eight months to get that cracker up and running from the time that we started up and we had multiple challenges and issues. I think that we had a dedicated project team of strong ops people on this project from the very beginning on the design, all the way through the construction and the startup of the facility. I think that really helped. I think that as we watched the construction and we were going to the fabrication sites, we had better quality control this time, and so we just didn't see the equipment issues starting up this facility. The construction, while we were probably late by six to seven months and we were disappointed with that, the overall quality of this construction was very, very good.

Manav Gupta:

I see. Great job, guys. Second question is on the Gulf Coast, it's good to see meaningful contribution for the refining earnings on the Gulf Coast. Can you talk about how Bayou Bridge adds to this positive momentum and uplift you get once you get the second leg completed?

Greg C. Garland:

Well, now, certainly I think Bayou Bridge is an important asset for us and we're running barrels over to our Lake Charles Refinery. Obviously we get the fee for moving the barrel, but on a general interest basis, on I don't know, 80,000, 90,000 barrels a day we're probably picking up $1.00 a barrel or something like that for the general interest of the Company, which is really a strong performance. We're anxious to get the pipe to St. James completed this year. And then we're also looking at running pipe to St. James down to Alliance. Ultimately, we want to connect all of our Louisiana refineries with the Texas Gulf Coast. From a general interest perspective, we think that's good.

Then the other thing I would just say about the Gulf Coast, we import a lot of Canadian heavy down. We run all we can; we sell the rest. But we've got Canadian heavy into Sweeny this quarter, some into Lake Charles. Obviously, Lake Charles benefited by the Maya-LLS also, and so things just worked well for us in the Gulf Coast this quarter.

Manav Gupta:

Great. Last question is that ethane prices have moved up to $0.35 per gallon and I was wondering if you could talk about how that impacts your entire NGL business, and does that actually change your view of how you intrinsically value DCP?

Greg C. Garland:

Well, I think that there's no question NGL prices have moved up. I don't think they moved up as much as people expected them to at this point in the cycle, given three cracker startups, each needing about 90,000 barrels a day of ethane. So, I mean, we continue to like DCP. There's no question that a higher NGL price for the barrel also benefits them to the extent that we're pulling more ethane out of the rejection in the areas where DCP contributes, that's also very positive towards DCP. But it doesn't fundamentally change our view on DCP. We like DCP, we like the asset footprint they have in the Eagle Ford and the Permian and the Midcontinent, particularly in the DJ Basin. So, you know, good assets for DCP.

Manav Gupta:

Thank you so much, guys.

Greg C. Garland:

You bet.

Operator:

Matthew Blair from Tudor, Pickering, Holt, please go ahead. Your line is open.

Matthew Blair:

Hey, good morning, everyone.

Jeff Dietert:

Good morning.

Matthew Blair:

Greg, I was wondering, does CPChem have any interest in adding more ethylene derivative capacity? I know you've run more of an integrated model here, but we're looking at pretty low ethylene spot prices and if we look out over the next five years or so, we definitely see a lot more cracker capacity coming online than derivative capacity; I'm not sure if you agree with that. I think you mentioned previously that PE demand growth was strong, so what kind of interest, if any, would you have in, say, like a standalone PE unit to take advantage of some of these trends?

Greg C. Garland:

Well, first of all, I'd say if you don't like the ethylene spot price today just hang around a little bit because it's going to change. Look, CPChem generally runs just slightly long on ethylene. We like to be relatively balanced and so I wouldn't be surprised to see them add or de-bottleneck some derivative capacity. To your question: would we build speculative derivative capacity based on someone else's long? I don't think so. The reason is, we want to capture that value through the whole chain. If you look, that value moves, right. It's not always in the derivative; sometimes it moves to the ethylene side, and so we like that integration and to be able to participate in that whole value chain.

Matthew Blair:

It makes sense. Then on heavy Canadians, Enbridge made some progress in their Line 3 replacement recently. I don't think Phillips is much of a shipper on Enbridge, but, regardless, it would add more WCS to the overall U.S. supply mix. How much of an appetite would you have to run additional WCS in either your central corridor or Gulf Coast system? Are you pretty maxed out or could you ramp runs if more supply was available?

Greg C. Garland:

Yes. We're bringing over 500,000 barrels a day Canadian crude in today, so we're the largest importer of Canadian crude. We're probably running about 80% of it or so, I would guess. I don't know, Jeff, if you've got the exact number, but it's right in that range. We're kind of maxed out on Canadian heavy today.

Jeff Dietert:

Yeah, about 80% of that is heavy and we are running what we can. We're not big shippers on Enbridge, Matthew.

Matthew Blair:

Great. Thank you very much.

Operator:

Craig Shere from Tuohy Brothers, please go ahead. Your line is open.

Craig Shere:

Hi. Congratulations on the great quarter.

Greg C. Garland:

Thank you.

Craig Shere:

You know, I understand nothing's really changed in terms of capital allocation and we at least want to pay back another $1 billion, maybe $1.25 billion on the debt we took out for the share buyback in the first quarter. But it sounds like there's a vision here of maybe a really nice, call it, two- maybe three-year kind of one-time-ish very strong cash flows on the low inventories, but leading into IMO 2020. And of course, the thinking that eventually that will get worked up by the market, but what do you do with a windfall? I mean, if you come up with an extra couple billion dollars and you don't think it's repeatable, how do you think about that?

Greg C. Garland:

Look, well, first of all, what a great problem to have, but, I think our fundamental capital allocation strategy, which has served us well for six years really isn't going to change. We kind of think about the 60/40, 60% of our cash available from all sources we want to reinvest in our business to the extent that we have opportunities that we can generate acceptable returns, and then 40% we're going to give back to shareholders through a strong secured growing dividend and share repurchase as long as we're trading below intrinsic value on the share repurchase side.

We continue to look three years out. Sum of the parts, historical multiples, and if that value is higher than the price in the market, we're buying. We're buying today in the market. I don't think that fundamentally changes. Maybe we hold a little higher cash, maybe we pay down a little more debt along the way, but fundamentally, you're not going to see us change our capital allocation strategy.

Craig Shere:

In terms of the reinvestment, we had a little temporary hiatus as we worked down some massive project portfolio. Then you announced Gray Oak and Sweeny Frac's expansions. How much after that do you think we have? I mean, as we look into the early 2020s, do you think there's the ability, if the cash flow materially increased, to take it up to $3 billion to $4 billion in growth capex on an annual basis for a couple of years?

Greg C. Garland:

I think the portfolio is going to generate $5 billion to $6 billion of cash. We've got $1 billion of sustaining capital. We want to fund kind of another billion to $2 billion of growth, so call it $2 billion to $3 billion of capital. That takes care of that.

We have $1.5 billion dividend today and that leaves room for another $1 billion to $2 billion of share repurchases, and that kind of all balance within our means. I think that you'll continue to see us work that.

I do think there's going to be other opportunities. We'd like to do Frac 4 out there in the future. There may be more pipe opportunities, more export-oriented opportunities for us as we think about 2020 and beyond. I think we've got a good run in front of us in terms of just the opportunity set that we see around infrastructure, Midstream, and, of course, the petrochemicals business.

Craig Shere:

Great. Thank you.

Operator:

We have no further questions at this time. I will now turn the call back over to Jeff.

Jeff Dietert:

Thank you, Julie, and thank you for your interest in Phillips 66. If you have additional questions, please call Rosy or me. Thank you.

Operator:

Thank you, ladies and gentlemen. This concludes today's conference. You may now disconnect.