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TSO - Q3 2017 Andeavor Earnings Call

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OVERVIEW:

Co. reported 3Q17 earnings of $551m and diluted EPS of $3.49.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Q3 2017 Andeavor Earnings Conference Call. (Operator Instructions) As a reminder, this conference is being recorded for replay purposes. It is now my pleasure to turn the conference over to Brian Randecker. Sir, you may begin.

Brian Randecker - *Andeavor - CFO of Refining & Senior Director of IR*

Thank you. Good morning, and welcome to today's conference call to discuss our third quarter 2017 earnings. Joining me are Greg Goff, Chairman and CEO; and Steven Sterin, Executive Vice President and CFO.

The earnings release, with can be found on our website at andeavor.com, includes financial disclosure and reconciliations for non-GAAP financial measures that should help you analyze our results.

Our comments and answers to questions during this call will include forward-looking statements that refer to management's expectations or future predictions. They are subject to risks and uncertainties that could cause actual results to differ from our expectations. Please refer to the earnings release for additional information on forward-looking statements.

Andeavor and Andeavor Logistics will be holding an Investor and Analyst Day in New York on December 5 at 9:00 a.m. at the St. Regis Hotel. The registration instructions are detailed in the third quarter earnings release. For additional details on this event, please follow up with our Investor Relations team.

Now I'll turn the call over to Greg.

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Thanks, Brian. Good morning, and thank you for joining us today. Our business delivered strong results across our integrated value chain during the quarter. Our Marketing business is well positioned for continued growth following the integration of Western's retail business and the recent acquisition of 39 convenience stores in Northern California, both which bring more secure and profitable earnings to the portfolio.

Our Logistics business completed the acquisition of Western Refining Logistics and the IDR Buy-In transaction. The completion of these 2 transactions lowers our cost of capital and positions us to capture organic growth opportunities across our geographic footprint. We are especially excited about our portfolio of growth opportunities in the prolific Permian Basin.

Before we review our third quarter results, I would like to update you on our integration of Western Refining. We continue to have a very successful integration and are rapidly moving forward towards full integration and value capture. We are making excellent progress integrating the business and identifying and capturing synergies. We remain committed to delivering an expected $350 million to $425 million in annual run rate synergies by June 2019, the second year following the close of the transaction. This includes approximately $120 million to $160 million from value chain optimization, $130 million to $140 million from operational improvements and $100 million to $125 million from corporate efficiencies.

By the end of the third quarter 2017, and only 4 months since close, we estimate we have achieved approximately $110 million in annual run rate synergies, consisting of approximately $85 million of corporate efficiencies and approximately $25 million in value chain optimization and operational improvements. We have clear plans to achieve the full run rate.

Turning to our operations for the quarter. First, within Marketing. We are committed to driving growth and improvements in our Marketing business by focusing on placing product into the highest value-branded distribution channels, adding new retail sites to the network and implementing store improvements to enhance our convenience store position.

During the quarter, we closed the acquisition of 39 high-quality convenience stores primarily in Northern California. This acquisition further strengthens our integrated business by expanding our retail presence in Northern California, by adding approximately 6,000 barrels per day of branded sales as well as nonfuel income. These company-operated stores allow us to capture the full value at the sites. We expect these sites to contribute $10 million of annual net earnings and $25 million of annual EBITDA.

Mexico continues to be a focus within our Marketing business as it extends our West Coast value chain south to the northwestern part of Mexico and our progress so far is encouraging. At the beginning of the third quarter, we announced that we signed a terminalling and transportation services agreement with Pemex, which allows the potential to supply 30,000 to 40,000 barrels per day of transportation fuels in the states of Sonora and Baja California in Mexico. We also announced we signed a wholesale supply agreement to begin wholesale marketing operations using the ARCO brand.

We efficiently began operating in Mexico and successfully opened the first ARCO station in Tijuana, Mexico on August 29, 2017. We now have 5 stores in Mexico as of November 2, and we have seen strong customer acceptance of these ARCO sites with fuel sales up considerably versus the stores prior to the conversion. We are also on track to add stores as we move through the fourth quarter.

We will continue to grow our integrated footprint, and the company expects to increase its marketing presence across the entire northern part of Mexico with an estimated 200 to 300 stores planned over just the next few years.

Moving to Logistics. We had strong performance in the quarter led by record volumes in our terminalling business, driven by strong refined product demand and high refinery utilization and volume growth and increased throughput in the gas gathering and processing business driven by North Dakota Gathering and Processing Assets acquisition.

Yesterday, we announced we dropped the Anacortes logistics assets from Andeavor for total consideration of $445 million. This represents about 8.5x annual EBITDA multiple and will result in nearly $400 million in cash flow to Andeavor in the fourth quarter.

On October 30, Andeavor Logistics completed its $1.7 billion acquisition of Western Refining Logistics and the $3.6 billion IDR buy-In transaction with Andeavor. The completion of these transactions is extremely important to our cost of capital, which supports our long-term growth and further strengthens Andeavor Logistics as a premier customer-focused logistics company.

As a result of the WNRL acquisition, Andeavor Logistics is well conditioned -- positioned to compete and grow organically in the highly attractive Permian Basin, principally in the Delaware Basin where Andeavor and Andeavor Logistics have a strong logistics asset base, crude oil marketing capability and meaningful refining offtake.

Our first large project in the Permian, the Conan Crude Oil Gathering Pipeline system, is progressing well and on track to start up early operations this quarter and full operations in the middle of 2018. We look forward to sharing more about our strategies for further growth in the Permian at our upcoming Investor and Analyst Day.

The financial repositioning dramatically reduces the need for new public equity issuance, and the investment-grade credit rating substantially reduces the cost of capital to support sustainable long-term growth. This benefits Andeavor since we own approximately 59% of this company as well as the Andeavor Logistics third-party unitholders benefit.

We continue to see substantial growth potential for this business and expect at least $1 billion of annual growth investments for Andeavor Logistics over the next several years. This consists of at least $500 million to $600 million in organic growth and acquisitions and the potential for $400 million to $500 million in dropdowns from Andeavor.

Our Logistics business is a significant part of the value proposition for Andeavor investors. The growth in this business brings more stable fee-based earnings and cash flow to Andeavor. As I mentioned earlier, Andeavor owns approximately 59% of Andeavor Logistics common units, which are valued at approximately $5.8 billion using Andeavor Logistics closing price of $45.47 from yesterday.

Now shifting to refining. Total refining throughput was 1.1 million barrels per day or 99% utilization. Refining margin was $15.09 per barrel. We had strong operating performance during the quarter and throughput was in line with our expectations. However, we did experience additional costs and extended downtime during the planned FCC or fluid catalytic cracker unit turnaround at the Martinez Refinery.

Turning to our outlook for 2017. We continue to expect an annual Andeavor index of $12 to $14 per barrel and annual Marketing segment fuel margins of $0.11 to $0.14 per gallon. Additionally, we remain committed to delivering an estimated $475 million to $575 million of improvements to operating income in 2017, which is comprised of $395 million to $475 million from growth and productivity and $80 million to $100 million from higher throughput and other operational improvements. In fact, we expect to be at the upper end of our original outlook, and through the third quarter 2017, the company has delivered approximately 80% of the improvements.

I would like to be clear that these improvements do not include the expected synergies from the Western acquisition.

Before I conclude, we look forward to seeing you on December 5 at our 2017 Investor and Analyst Day where we intend to update you on Andeavor and Andeavor Logistics, our strategic outlook and outline our plans for the next few years.

With that, I'll turn the call over to Steven to provide more detail of our third quarter financial and operational results.

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Thanks, Greg.

Yesterday, we reported Andeavor's third quarter 2017 earnings of $551 million or $3.49 per diluted share compared to $170 million or $1.43 per diluted share a year ago. Consolidated net earnings were $601 million for the third quarter compared to $201 million for the same period last year, and EBITDA was $1.2 billion compared to $577 million a year ago.

Overall, we had strong results across the integrated business. Keep in mind the third quarter 2017 results included the following pretax items: a $209 million benefit related to an LCM inventory adjustment; a $19 million environmental accrual related to the expected final remediation costs for the 2013 crude oil pipeline release at Tioga, North Dakota; acquisition and integration costs of $32 million related to the Western Refining acquisition; and $13 million of acquisition costs related to Andeavor Logistics acquisition of WNRL and the IDR buy-in transaction.

In addition, a planned turnaround at the FCCU at Martinez Refinery was extended from mid-August into early September. The extension and other unplanned maintenance associated with the restart negatively impacted operating income by an estimated $42 million.

Third quarter 2016 results included a pretax benefit of $20 million related to an LCM inventory adjustment.

Turning to our business segments. In Marketing, segment operating income was $175 million and segment EBITDA was $193 million for the third quarter 2017 compared to segment operating income of $273 million and segment EBITDA of $285 million a year ago. Total fuel margins were $0.10 a gallon versus fuel margins of $0.149 per gallon a year ago.

During July and August, Marketing margins were weaker than usual as the station price lagged the increase in the spot market. By September, margins were back to normal levels. We still continue to expect Marketing segment fuel margins to average $0.11 to $0.14 per gallon over time.

Retail and branded fuel margins were $0.193 a gallon compared to $0.253 per gallon in 2016.

Merchandise margin increased to $54 million from $3 million in 2016 driven by the new company-operated stores we acquired as part of the Western acquisition.

We continued to grow our network of branded stores, growing store count by 657 or 27% year-over-year to 3,124 stores. This was primarily driven by the additional stores from the Western and Northern California Retail acquisitions and the continued execution of the company's organic growth plan. In fact, our organic growth plan execution has resulted in the addition of 74 net new branded stores year-over-year and continues to grow. We also expect the initial conversion of approximately 50 stores from MSO to company-operated in the fourth quarter given the capabilities of a retail group that joined the company as part of the Western acquisition. This conversion will allow us to begin to capture additional nonfuel margins and enhance overall station profitability.

Shifting to Logistics. Segment operating income increased to $164 million in the third quarter from $127 million a year ago, and segment EBITDA grew to $252 million from $177 million last year.

As a reminder, the segment's results included the $19 million environmental accrual related to the expected final remediation costs at Tioga, North Dakota. Results also included $9 million of acquisition costs related to Andeavor Logistics' acquisition of WNRL and the IDR buy-in transaction. We expect to see an additional $8 million of acquisition and transaction-related costs in the Logistics segment in the fourth quarter. These are transaction-related costs that could be recognized until the actual closing of the transaction, which occurred on October 30.

The increase in segment operating income and segment EBITDA was primarily driven by strong refining utilization and summer demand for refined products, contributions in the North Dakota Gathering and Processing Assets acquisition completed in early 2017, contributions from the dropdowns we completed in 2016 and our Permian and Northern Great Plains logistics and wholesale operations added as part of the Western acquisition.

The total general partner and limited partner distributions received by Andeavor were $94 million during the third quarter. This is an increase of $29 million from a year ago.

Moving to Refining. Segment operating income was $762 million for the third quarter compared to $58 million a year ago, and segment EBITDA was $940 million versus $208 million last year.

Refining margin for the third quarter was $1.6 billion or $15.09 per barrel. This compares to a refining margin of $729 million or $9.08 per barrel last year.

When comparing our third quarter 2017 segment operating income, segment EBITDA and Refining margins to the same period last year, please note that the results included in the third quarter of both years included pretax benefit due to the LCM adjustments of $209 million in 2017 and $20 million in 2016. This equates to approximately $1.99 a barrel and $0.25 a barrel of increased margin on a per-throughput basis for 2017 and 2016, respectively.

So other than the LCM impacts in both quarters and the extended FCCU turnaround and restart in Martinez, the significant year-over-year increase in Refining margin reflects the continued delivery of our improvements to operating income, contributes the -- contributions from the Western acquisition and an overall stronger refining crack spread environment.

In our Pacific Northwest and Mid-Continent regions, throughput was at the high end of our expectations as all of our refineries ran very well.

In our California region, crude unit throughput and costs were in line with our expectations. However, capture was partially offset by the extended turnaround in Martinez.

Now let me take a moment to discuss our balance sheet, cash flow and our strategic priorities for creating long-term shareholder value. Following the completion of Andeavor Logistics' acquisition of WNRL and the IDR buy-in, S&P raised Andeavor Logistics' corporate credit and senior unsecured issue ratings to investment grade with a BBB- rating and a stable outlook from BB+.

As a reminder, in February 2017, Fitch assigned a first-time, long-term issuer default rating of BBB- to Andeavor Logistics, marking the company's inaugural investment-grade credit rating.

As a result of us achieving an investment-grade credit rating at both S&P and Fitch, Andeavor Logistics' outstanding unsecured bond securities now meet the criteria to be included in the investment-grade bond indices. With our new investment-grade credit rating, Andeavor Logistics joins Andeavor as an investment-grade company and is well positioned to optimize its capital structure and meet future financing needs at attractive rates with longer maturities in a more liquid market.

Additionally, on October 26 of this year, Moody's upgraded Andeavor Logistics' corporate family rating to Ba1 from Ba2 while maintaining its positive outlook on the company. This is one notch below investment grade.

Our balance sheet and credit metrics remained strong. We ended the quarter with a consolidated cash balance of $528 million. The reduction in cash sequentially from the second quarter 2017 is primarily due to the timing of working capital and the acquisition of the 39 retail stores mentioned earlier. We expect working capital to be substantially lower in the fourth quarter given the unwinding of the third quarter seasonally high inventory levels.

Total debt net of unamortized issuance cost was $7.7 billion at the end of the quarter. Excluding Andeavor Logistics and WNRL debt, total debt was $3.6 billion.

Andeavor generated cash flow from operating activities of $431 million in the third quarter.

During the quarter, we invested $114 million in high-return growth capital projects at Andeavor and Andeavor Logistics.

Our combined capital expenditures including income capital, sustaining and maintenance was approximately $398 million consisting of $339 million for Andeavor, $51 million for Andeavor Logistics and $8 million for WNRL for the third quarter.

We repurchased 2.6 million shares for approximately $252 million in the third quarter and had approximately $1.7 billion remaining under our approved share repurchase programs as of September 30.

Additionally, we paid dividends of $93 million and Andeavor Logistics distributed $105 million to its public unitholders during the quarter.

In addition to the $400 million of share repurchases we have done through the third quarter, we expect to repurchase $300 million of shares in the fourth quarter.

Yesterday, we also announced that the Andeavor Board of Directors declared a quarterly cash dividend of $0.59 per share payable on December 15, 2017, to all holders of record as of November 30, 2017.

Turning to our 2017 capital outlook. We anticipate full year 2017 capital expenditures to be approximately $1.3 billion, consisting of $1.05 billion at Andeavor, $245 million at Andeavor Logistics.

Refining turnaround cash expenditures for the full year 2017 are expected to be $540 million and Retail branding expenditures are expected to be $100 million.

Looking ahead, you can find details of our planned throughput, manufacturing cost per barrel and other elements related to our fourth quarter 2017 outlook in our earnings release issued yesterday evening.

This concludes our prepared remarks, and we will now take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question will come from the line of Neil Mehta with Goldman Sachs.

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

The first question I had was just around the Marketing segment in the third quarter. And so, Greg, if you could just talk a little bit about whether there was some elements of margin compression given the hurricane or other factors that might have tightened up those margins, and we don't have those retail indicators to kind of monitor on a weekly basis anymore. So just any thoughts on the environment as you look into the fourth quarter here for the Marketing business and as you go into 2018.

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes, Neil. During the third quarter, what happened is, in the early part of the quarter, the spot prices for gasoline were moving up pretty rapidly and the pricing at the station level just did not keep pace with the movements, which, as you know, kind of happens quite often. And that proceeded through the first part of the quarter and then it turned around in October and The Street prices caught up with the spot prices for product and the margins were kind of back to where they normally were at. We had a very good quarter, and they've continued to be there through the first month of the fourth quarter. So I think it's basically just that movement of rapid movement of prices and unable to keep up with them at the store level.

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

That's helpful, Greg. And then the follow-up is just around the share repurchases. It sounds like you guys have been blacked out for much of the quarter, probably next week you'll be able to really execute this $300 million program through the end of the year. How do you think about what the right run rate is post the fourth quarter? Is the $300 million run rate a sustainable one? And then if you can just talk about how you think about buybacks versus the dividend. We had the 7% dividend bump, but given the performance of the stock and the current yield, is there an opportunity to be more aggressive there?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes. First, as you know, Neil, the $300 million in the fourth quarter goes along with the $400 million that we bought earlier, so we expect for 2017 that we will repurchase approximately $700 million worth of shares. Secondly, you recall when we announced the transaction with Western, we stated our intent, because we issued equity, to have a buyback program, which our board authorized us up to $2 billion at that time to do that, and we stated we would go back in and repurchase shares as we manage through the year in that. So as we look forward into 2018, our use of cash remains unchanged. We have a very active reinvestment program on our capital projects, which we'll share at our Analyst and Investor Meeting in December because of the big projects like the project up in Anacortes, the project at Los Angeles. And then we, based upon projections for the margin environment, that we see the opportunity to use free cash flow to repurchase shares during 2018, which we will do like we always have from an opportunistic standpoint as we manage the company through the year. We don't see any changes in that approach there, and we're completely committed to the repurchase program that we talked about earlier.

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

And the dividend...

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes, sorry, the dividend, you're exactly right. We increased it at our last -- during the last quarter, and we typically go back and look at the dividend on an annual basis and we will continue to do that. So we will look at our dividend and manage it as part of our overall cash management for the company.

Operator

And our next question will come from the line of Doug Leggate with Bank of America.

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

I've got 2 fairly high-level ones, if I may. I guess, the first one is on the cash, as a follow-up to Neil's, I guess, on the cash balance. Can you talk about -- this is the lowest cash balance you've carried in quite some time. I'm just looking at the operating cash flow in the quarter and the capital plan, it kind of gets to this issue of the sustainability of the buyback. I just wondered if you could walk us through any unusual items this quarter, working capital perhaps, and how you expect -- where you would expect to manage that cash balance going forward. And I've got a follow-up.

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes, it's a good question, Doug. Let me ask Steven to share what's going on with that.

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes, Doug, there's been really no change at all to how we think about managing the balance sheet and having strong liquidity position. And in the third quarter, we had 2 things: one, we acquired for about $175 million the retail stations, we used cash for that. In addition, just based on seasonality and just timing, we had about $400 million to $500 million of working capital that we expect to come back to us in the fourth quarter. And so when we look over the second half of the year, we'll be right back to where we expected to be and to have very, very strong cash from operations as we've had over the last several years, which gives us the confidence that Greg mentioned to be able to repurchase shares, continue to execute our growth plans and maintain a very strong balance sheet.

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes, just to add to what Steven -- just to make one more addition. What Steven said on the working capital, it's associated with the inventory level that we carried into the third quarter that we're now reducing. So it was just a temporary aberration.

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

That is the number I was missing, guys, so that makes it very clear. My follow-up is kind of an enigma wrapped inside a conundrum, I think is the expression, but -- so I wonder if you could help us, maybe, Steven, think about how we treat the valuation of the MLP now that it's such a large part, 59% of the LP ownership. Greg, you mentioned $5.9 billion of value, but obviously every time you take a distribution, your tax basis goes down. So as a C corp, you obviously have a tax liability on that whereas the publicly traded value is free of tax. How should we think about the after-tax valuation as it relates to how much of that $5 billion -- $5.9 billion actually translates to, let's say, Andeavor sum of the parts? And I'll leave it there.

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes, I would say, first, I mean, obviously that's a point in time. And when we look at the intrinsic value of our Logistics business, it's based upon its ability to generate cash and we don't think that's reflected at all in the current unit prices and yields. And we have a lot of growth in front of us. And at the end of the day, the value to Andeavor unitholders is that cash flow. We don't have an intention to sell those units, so we don't think about it being worth less because of tax. I would encourage you to think about the future cash flows that come from this high-growth business that's got a low cost of capital and it's got access to several different sources of funding and now 60% of that cash flow will clearly flow to Andeavor, 59% is our current ownership. And so I'd encourage you to think about it economically. From time to time, it's easy to take a look at the unit price and multiply it by the 59% ownership, but unless your intrinsic value is represented of the future cash flows, I think that underrepresents the real value that's within our investment.

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

Yes, Steven, I appreciate the answer. Don't want to labor it too much, but just a couple of points of clarification. So first of all, the value on the screen is the value today, right, so...

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes.

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

We obviously -- that's what I'm referring to, but maybe the way to ask the question is what is the tax treatment of the distributions you received at the Andeavor level as opposed to the price on the screen, which obviously will change over time?

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes, for the most part, it's just part of our taxable income base. And so just like other cash flows within the business, think about when you look forward to the net present value, that cash being discounted back after tax just like you would any other cash flows.

Operator

And our next question will come from the line of Brad Heffern with RBC Capital Markets.

Bradley Barrett Heffern - *RBC Capital Markets, LLC, Research Division - Associate*

So Steven, I think in your prepared comments, you talked about converting some of the retail stores from the MSO model back to company-operated. Can you talk a little bit about sort of the cadence there and how that works? I assume you have to buy out the MSOs.

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Brad, let me take that question. So Steven laid out the early part of our plans that during the fourth quarter we begin converting the MSOs, which we've had in place for a number of years back to company-operated stations for us, and that's part of our overall plan to enhance the value really of our Marketing business. There's the nature of the contracts and that doesn't make it a very capital-intensive process to be able to do that, so it's not a significant impact from a cost to do the conversion. They were relatively short-term contracts that have provisions that make the transition back to us pretty easy.

Bradley Barrett Heffern - *RBC Capital Markets, LLC, Research Division - Associate*

Okay, got it. So like what kind of time period are we thinking about to do the conversion for the bulk of the MSOs?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Over the next little bit, we'll continue to do the whole transition. So part of it you could well appreciate is, over the years, we kind of dismantled the organization to support those like out in the field and all of that. So we need to do that in an orderly fashion so that we can successfully integrate them back in the business. So probably a good approach is that in this quarter, as Steven said, we'll bring in the first 50 stations and that's kind of what we feel like we can manage on a quarterly basis.

Bradley Barrett Heffern - *RBC Capital Markets, LLC, Research Division - Associate*

Okay, great. And then a question on Refining. You guys typically have like a 6% or 7% volumetric uplift every quarter, just yields over throughput. This quarter, it looked pretty flat, so I was wondering if there's anything going on there. Obviously, I'm sure some of it was the FCC turn at Martinez, but I think it was also a phenomenon that happened in the Pacific Northwest as well.

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes, it was principally related to Martinez and the rest of the system ran very well. And so that's the primary driver of it. And keep in mind, the $42 million that we talked about was the impact of the extension, but the FCC was down also for the month of July as well and so think about it as primarily Martinez.

Operator

And our next question will come from the line of Phil Gresh with JPMorgan.

Philip Mulkey Gresh - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

First question just to be on the Mid-Con side in Refining given that this is the first full reported quarter with WNR kind of in the numbers. You had a change your indicator and things like that so it's a little bit kind of tough to model. I'm just curious if, from your perspective, the results in the

Mid-Con region where kind of in line with what you would have expected from a capture rate perspective. Is this the run right rate to be thinking about in this type of crack environment or anything, in particular, that you'd call out?

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes. When you look at the Mid-Con, we had a Refining gross margin excluding LCM of $15.55 a barrel. And you look across other margins outside of our company in the Mid-Continent, that's a very, very strong result. That's both our operating performance as well as the addition of El Paso, Gallup and St. Paul. And so we're very pleased with that type of gross margin in the Mid-Continent. In terms of the capture rate with our index, if you think about being in the high 70s, low 80s, depending on crude differentials, that's what you should expect over time, and we were in the high 70s this quarter. Q2, we only had 1 month in and so you saw a bit higher -- a much higher capture rate, but those just because we only had 1 month of the new business as part of the portfolio. So Q3, I think is a much better benchmark for thinking about how our Mid-Continent business performs post-acquisition and we hope to continue to improve that with the synergies that we've talked about because quite a few of them are -- a lot of them or most of them are within the Mid-Continent.

Philip Mulkey Gresh - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

Actually, this right into to my next question, which is just on the synergy side, it sounds like from your commentary, the vast majority of the synergies are just showing up in what would be the corporate segment at this point. And so it sounds like we're going to start to see that flow through the Mid-Con. But the synergy -- sorry, the corporate guidance for the fourth quarter, that still includes integration costs that are ongoing, is that correct? I mean, at some stage, do those kind of roll off? Or how should we think about that?

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

No, the corporate costs right now run -- no, they don't include integration costs. We have a number of other projects that we're wrapping up around systems integration -- or we have a large systems improvement project that we have going in the fourth quarter and finishing in the first quarter. And at Analyst Day, because there's been so much this year, we've had a lot of acquisitions, a lot of integration costs, we'll lay out for you what we expect our corporate costs to look like over the next couple of years, but you can -- you should expect them to be substantially lower as we move into 2018 and 2019.

Philip Mulkey Gresh - *JP Morgan Chase & Co, Research Division - Senior Equity Research Analyst*

Right, okay. And I guess, the final one would be and I don't know if this is for the Analyst Day maybe, but you made the comment about the year-over-year improvement in Refining between cracks, the acquisitions, the operating improvements. It's been a little bit difficult to kind of see the operating improvement piece. If there's any way you could bridge that for us, that'd be very helpful.

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes, we intend to do that at the meeting in December, it's a good point.

Operator

And our next question will come from the line of Justin Jenkins with Raymond James.

Justin Scott Jenkins - *Raymond James & Associates, Inc., Research Division - Research Analyst*

I guess maybe starting on the midstream side with the dropdown and shift in capital spend on both L.A. integration and Conan from the MLP back to the parent. Can you talk about the strategy behind those moves? Is it just looking to further improve the positioning of the MLP? Or to be more efficient with the capital or any thoughts you have there?

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes, I think that both the Conan and LARIC projects are quite unique in not the normal way that we handle dropdowns and they're unique for distinctive reasons. First, the Los Angeles Refinery Integration Project, the pipeline bundle that we had always viewed as a logistics asset and will be a logistics assets is so intermingled with the overall project. That trying to split that out as we're doing the project doesn't create any value and so we'll bifurcate that and move that down into the Logistics business once the project's complete. And on the Western side, they had entered into the contracts for the Conan project at the parent company level just given their size of their MLP at the time and so that's a legacy that carried over. We'll complete that project, but that's always also been intended to be a Logistics project as well. And those projects, keep in mind, have allocated interest costs within them, and so from an Andeavor perspective, they represent the full cost of putting those projects together.

Justin Scott Jenkins - *Raymond James & Associates, Inc., Research Division - Research Analyst*

Perfect, that's very helpful, Steven. And then, I guess, maybe thinking about shifting gears to crude differentials, lots of interest in Brent WTI lately. Greg, was hoping to maybe get your views in terms of what you're seeing there and why we're still so wide on Brent WTI and maybe your outlook on Midland diffs as well?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes. I think probably can't add anything to the differential than what other people see. It's probably wider than we would expect it to be. We know that there's a lot of crude sitting in Cushing and moving into the Gulf Coast in that. So I think over time, it will probably stay at a little bit elevated level, but we expected in our planning to come down to a lower level beginning for 2018. But it has definitely been higher than what we expected to. The other differentials in the system are kind of where we would expect them to be, nothing special about them.

Operator

And our next question will come from the line of Spiro Dounis with UBS Securities.

Spiro M. Dounis - *UBS Investment Bank, Research Division - Director and Equity Research Analyst of Shipping*

Just want to start off on Mexico with the current footprint there, just maybe 2 things. Wondering when you start to really see that hit earnings? Or is it just too small for the time being? And as you think about the growth there, do you think about more along the lines of what you've been doing so far? Or do we see you expand more on the infrastructure side?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes, probably 3 points about Mexico. So one, as you would expect, it's a start-up business and so you're in the very early stages of putting in the whole infrastructure to support that business. Realistically, I would say before we start to see any impact to the bottom line, it's probably going to be in 2019 or '20. I mean, we'll see a small amount, but it's nothing of any significance. Second, I think the work so far, it's very, very encouraging. I actually went to Mexico and we had really an incredible grand opening day with a lot of support from potential companies to do business with in Mexico and it was very, very impressive. Our results, the company that we're working with right now, is they're doing an excellent job and the performance of the business is really -- it's fantastic, to be quite honest with you. And then, finally, we, our approach, that we have stated in Mexico is that we want to be able to take products that we make in our system along the West Coast, move it into a marketing system that we are involved in either through contractual relationships or potentially we will look to see if we want to own stations in Mexico, which is probably a little bit different approach. And as a result of that, your last question about the logistics system, it would be in our interest to be able to have an ownership position into the distribution system that we intend to use, and that's just something that we'll work on over time, well, to see if we're able to make that happen because we like the ability, just like in the rest of our system, to take the product from the refineries, control the movements all the way to the end customer.

Spiro M. Dounis - *UBS Investment Bank, Research Division - Director and Equity Research Analyst of Shipping*

Got it, that's good color. I appreciate that, Greg. And then just turning to synergies. I know you mentioned the operational improvements are tracking ahead of schedule. But as we think about the $110 million run rate on synergies, is that more or less on pace to with what you originally envisioned? And as we look forward to achieving the full target by mid-'19, would you say that's sort of linear glide path there? Or could it be choppy along the way?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

No. I think if you go back to Phil -- I mean, Phil highlighted the point about the corporate synergies. I mean, you would expect that, that those are the easier changes to make. When you combine 2 companies, those changes are -- they're just -- you're going to happen to capture those a lot sooner. And that's actually worked really, really well for us. The operational changes and improvements that we're going after, probably 2 or 3 points. One, we've done an excellent job of identifying those. We have them now put out into the organizations with clear accountability of delivering those. We're actually seeing some very encouraging things from that, for example. One, a synergy that really wasn't in our plan is that at the small Dickinson Refinery that we acquired in 2016, we're now able to take a naphtha that comes off of that facility and move it to St. Paul Park and convert it into gasoline where, in the past, that was going to move -- that was moved to Canada to be blended in with -- as a diluent so we get a substantial upgrade there. And so what's happened to us as we bring the people together and establish all the plans in that, we're seeing very good opportunities on synergies. And so we are very, very confident we'll do it. We see a very strong glide path, back to your question, so I think you'll see us be at a rate comparable to this year for next year also and hit that target in 2019.

Operator

(Operator Instructions) Our next question will come from the line of Paul Sankey, the Wolfe FA.

Paul Benedict Sankey - *Wolfe Research, LLC - MD and Senior Oil & Gas Analyst*

Only back to this operational thing, and I appreciate that the analyst meeting is coming up. There was -- you had a target of 98% operational uptime or something like that, Greg?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes.

Paul Benedict Sankey - *Wolfe Research, LLC - MD and Senior Oil & Gas Analyst*

Can you just specify what that was for us and if that's going be changed or whether you think that's still achievable? And also on the capture, I know you said that Martinez was really the majority of the problem, but it did still seem low and I wondered if there was anything to add on that.

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

So your first question, Paul, our target to get to what we call world-class availability of greater than 97% is absolutely still our target and we're working towards that, and it's really underpinned by our operational excellence management system to drive high reliability in the business. Just a comment about...

Paul Benedict Sankey - *Wolfe Research, LLC - MD and Senior Oil & Gas Analyst*

Greg, sorry, that's 97% availability of what sort? Remind me what the 97%...

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Of the whole system, all the refining units. That's all refining. So it's not just the crude units. I think, to be clear, it's how we would look at the performance of all of the units in the refinery, to have 97% availability of all the units greater -- we say greater than 97%.

Paul Benedict Sankey - *Wolfe Research, LLC - MD and Senior Oil & Gas Analyst*

And that's -- where did turnaround sit with that?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

So turnarounds, when they're planned, are taken out of that because, as you would expect, that's not there. Now in the case of when you have extended turnarounds, that's a negative impact on availability. So like Martinez, just to add a comment on Martinez that Steven talked about, the cat cracker at Martinez is designed differently than a lot of other cat crackers. And when you do, on the 5-year cycle, to do the turnaround, we knew going into the turnaround that the complexity of working the cyclones was a major challenge for us because of the way we have to get into the unit to do that and it took longer than we expected as we encountered some problems in that. So that would negatively impact the availability during the time. On capture things that Steven has already talked about, the $42 million is the total cost to run our business, so it's not just operating costs now, but it's to buy the product and everything for there. Also I think the high level of inventories probably impacted capture also during the quarter because, as Steven said, we intend to draw down between $400 million to $500 million worth of inventory during the fourth quarter.

Paul Benedict Sankey - *Wolfe Research, LLC - MD and Senior Oil & Gas Analyst*

Greg, I'll leave it there for the December Analyst meeting coming up.

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

While waiting for the next question, I would like to just make one clarification to an earlier question. Our guidance for corporate costs does include our integration costs this quarter as we're 2/3 of the way or 3 quarters away through that. So we're including those costs now in our outlook even though the release guidance says it doesn't. It absolutely does include the integration costs expected for the fourth quarter. So I just wanted to clarify my earlier comment.

Operator

And our next question will come from the line of Blake Fernandez with Scotia Howard Weil.

Blake Michael Fernandez - *Scotia Howard Weil, Research Division - Analyst*

Just two simple points of clarification really. I know you addressed Neil's question on the retail margins, and I fully understand the whole lag impact, and I guess, price gouging concerns impact in 3Q. And then ultimately that comes through in 4Q. If I'm not mistaken, didn't you guys use to provide a benchmark indicator in your index?

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes, we did provide that before. It used to be focused around the Southern California -- the California business in general. Back 2 years ago, that was where the majority of the Marketing business was focused. But as our businesses grown, and particularly with the Western acquisition, it's very difficult to provide an indicator on that. And so -- but the $0.11 to $0.14 per gallon takes all that into account. And so as we progress forward and we provide more information, particularly starting with the Investor Day, now that we've got fully integrated and much, much larger marketing business, we're looking at ways to provide you additional KPIs to be able to better understand that. But that -- but looking just at California now doesn't really give you enough information, so we'll look for other ways besides the broad $.011 to $0.14 guidance to help understand the growth within the business.

Blake Michael Fernandez - *Scotia Howard Weil, Research Division - Analyst*

Understood, but it sounds like you're solidly within that range here headed into 4Q, I guess?

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes, yes. Absolutely.

Blake Michael Fernandez - *Scotia Howard Weil, Research Division - Analyst*

The second one, Greg, I know you already talked about Mexico a decent amount. Mine is more of a macro-oriented question, I guess. This 30,000 to 40,000 barrels a day of product that you're hoping to move there, I'm just wondering, is that incremental product that is basically flooding the West Coast market today? I guess, what I'm asking is are there some indirect impacts that you're going to recognize on your West Coast refining system by moving incremental product out of that market?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Blake, I think from an overall standpoint, what's happened over time is there's been about 150,000 to 175,000 barrels a day of exports off of the West Coast into Mexico and Chile and Peru. About 2/3 of that is diesel and 1/3 of it is gasoline. We sometimes move that gasoline down into there. So that would say there's about a 50,000-barrel a day movement of gasoline off of the West Coast into Mexico and South America. From our standpoint, we're basically working to take and secure that 30,000 to 40,000 barrels a day of both gasoline and some diesel that we'll move in into Mexico over time. So it's from our -- it would be greater than what we've normally moved to Mexico, but this just sees how the industry adapts to that.

Blake Michael Fernandez - *Scotia Howard Weil, Research Division - Analyst*

So it sounds like it's more of capturing some margin on some barrels that are already making their way there, but maybe there are some incremental barrels that are going to leave the West Coast market as well, is that sort of fair or correct?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

That could be possible.

Operator

Our next question will come from the line of Roger Read with Wells Fargo.

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

Kind of a lot have been hit. And I know you don't want to talk too much forward. But if we could come back to that West Coast capture question that Paul was asking about, if we kind of add back the Martinez impact, you're still looking at a capture rate that would be the lowest in several quarters in the West Coast. You mentioned inventories, I assume, RINs might have been an impact. Was there anything else we should be thinking about? And then as you look at the fourth quarter, does the inventory pullout on a flat RINs market imply that capture should be back at sort of a longer-term average of, let's just say, Q4 performances?

Steven M. Sterin - *Andeavor - CFO, Executive VP of Corporate Development & President of Tesoro Logistics*

Yes. Roger, it's Steven. When you add back that $42 million, that gets you to a capture rate in the mid-70s, but that doesn't take into account the fact that for all of July, we were in that turnaround at Martinez with the FCC as well and so that affects your clean product yields. And so I think we wanted to point out to you the amount that was beyond what we had expected coming into the end of the quarter, but on a normal quarter, you should expect California to be back into the high 70s, around 80% with the new index.

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

Okay. Yes, that's helpful. And then one other Refining question, Pac Northwest really turned around this quarter compared to some prior. Is there anything in the Pac Northwest you'd call out as sort of a onetime event here? Or was it this really is maybe some things improving beyond just elevated cracks in the quarter?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes. No, nothing special going on in the Pacific Northwest from just -- it was pretty much normal operations for us during the quarter.

Operator

And our next question will come from the line of Chi Chow with Tudor, Pickering, Holt.

Chi Chow - *Tudor, Pickering, Holt & Co. Securities, Inc., Research Division - MD of US Refining Equity Research*

So I actually have a Mexico question as well. So you've got a 3-year term on access to the terminals, which gets you to 2020. Do you have some sort of automatic renewal or some -- like a right of first refusal on that agreement longer term?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes. We'll be -- I honestly don't know the terms right now. We'd have to go back and check on that, but we fully expect that once our position's established and it's working, that we'll be able to work with Pemex and renew our commitments there. But the exact commercial terms, I'm not sure what the duration is.

Chi Chow - *Tudor, Pickering, Holt & Co. Securities, Inc., Research Division - MD of US Refining Equity Research*

Does seem like the pretty critical assets, though, access to those terminals, right, to execute strategy, is that fair?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Absolutely. You're exactly right because our approach is to take product that we manufacture into Mexico, you're exactly right.

Chi Chow - *Tudor, Pickering, Holt & Co. Securities, Inc., Research Division - MD of US Refining Equity Research*

Do you have a feel for how Pemex may be opening up other parts of the country on further logistics access?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

There's been just lots of speculation in things that we don't know. We've heard that they intend to start moving to the other northern part going to the northeast of where they been, but we just have to hear what Pemex says about it and then prepare accordingly. So we don't have very good information on that.

Chi Chow - *Tudor, Pickering, Holt & Co. Securities, Inc., Research Division - MD of US Refining Equity Research*

Okay, okay. And the second question a little longer term on the MARPOL 2020 bunker fuel change, how are you thinking about the market impacts? And are you considering an additional capital projects to take advantage of that situation?

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes, we've been doing our 5-year plan. We just actually finished it here in the last little bit. And as you would expect, the change, if it comes about, as everyone expects it to, has some pretty significant impacts on a number of prices and the supply of certain products in that into the market, so we are looking closely to that. And yes, we do have some plans or we don't see a lot of capital needed to adapt to what we're going to do. But we do have very clear plans on how we'll position the company to manage the change as it happens there. So it's, I mean, it looks to be something that we can handle very easily and that, it depends on your views, has potential upside because of diesel prices.

Chi Chow - *Tudor, Pickering, Holt & Co. Securities, Inc., Research Division - MD of US Refining Equity Research*

Yes, it seems like a big change to the market coming up here.

Gregory J. Goff - *Andeavor - Chairman, CEO & President*

Yes, it does.

Operator

Ladies and gentlemen, this concludes our question-and-answer session for today. We would like to thank you for your participation on today's conference, and you may now disconnect. Everybody, have a wonderful day.