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TLLP - Q3 2016 Tesoro Logistics LP Earnings Call

EVENT DATE/TIME: NOVEMBER 01, 2016 / 4:00PM GMT



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Jeremy Tonet *JPMorgan - Analyst*

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Ryan Levine *Citigroup - Analyst*

PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Tesoro Logistics third-quarter 2016 earnings conference call.

(Operator Instructions)

As a reminder, today's conference is being recorded. I would now like to introduce your host for today's conference, Mr. Evan Barbosa, Investor Relations Manager. Sir, please go ahead.

Evan Barbosa - *Tesoro Logistics LP - IR Manager*

Good morning and welcome to today's conference call to discuss our third-quarter 2016 earnings. Joining me are Greg Goff, Chairman and CEO; Phil Anderson, President; and Steven Sterin, CFO. The earnings release, which can be found on our website at tesorologistics.com, includes financial disclosures and reconciliations for non-GAAP financial measures that should be used to 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. Now I will turn the call over to Phil.

Phil Anderson - *Tesoro Logistics LP - President*

Thanks, Evan. Good morning and thank you for joining us today. I will review our third-quarter performance and then turn the call over to Greg. Yesterday we reported third-quarter net earnings of \$87 million, an increase of 23% from a year ago, and EBITDA of \$181 million, up 18% from a year ago.

Please note net earnings and EBITDA for the third quarter included charges of \$2 million for losses on asset disposals and \$1 million of losses attributable to predecessor. For the third quarter, net cash from operating activities grew 28% year over year to \$176 million, and distributable cash flow grew 16% year over year to \$133 million.



These increases demonstrate execution on our strategy to grow the business through optimization, organic investment, and strategic acquisitions. On October 19, we announced our third-quarter distribution of \$0.875 per limited partner unit, or \$3.50 per unit on an annualized basis, which was our 22nd consecutive quarterly distribution increase of approximately 4% or more and represents a 17% year-over-year increase.

Our distribution coverage ratio was 1.02 times for the third quarter and 1.10 times for the trailing 12 months. I would also note that we ended the quarter with approximately \$500 million of cash. Third-quarter coverage is lower due to the 6.3 million new units we issued in June, as well as units issued to Tesoro during the quarter in connection with the Alaska storage and terminalling assets acquisition.

Moving to our operations for the third quarter, the gathering and processing segments have faced significant headwinds this year, with reduced upstream activity driving declines in production in the Bakken and Rockies regions. Our execution is focused on capturing demand to clear barrels from the basin as well as optimizing the operations in the Rockies.

In our gathering segment, operating income was \$31 million compared to \$42 million a year ago, and segment EBITDA was \$50 million versus \$60 million last year. About half of the difference versus last year relates to the deconsolidation of RGS, and the remainder mostly reflects lower natural gas gathering volumes.

Gas throughput in the third quarter was 887,000 MMBtus per day, compared with over 1 million MMBtus per day in 2015. Throughput in the third quarter 2015 included 142,000 MMBtus per day related to third-party RGS volumes that are no longer included.

Sequentially, volumes improved, driven by increased drilling and completion activities which may provide support for volumes going forward as the rig count in the area has recently increased. We are nearing completion of our Uinta compression project that will support additional drilling in the Red Wash area, an area of high potential growth for the system.

Additionally, we are beginning construction on a new compression project to support new drilling in the Vermillion Basin in Wyoming. We expect to complete this project in mid-2017.

Crude oil gathering throughput was 206,000 barrels per day, which was an increase of 4% year over year driven by continued demand for deliveries to basin takeaway pipelines. We are nearing the completion of two pipeline interconnections on the High Plains crude oil system.

We also intend to complete the connection to Tesoro's Bakken link pipeline and the Dakota Access pipeline in the fourth quarter of 2016 and the first quarter of 2017 respectively. In the processing segment, segment operating income was \$29 million, and segment EBITDA was \$40 million, both flat versus the prior year.

Keep-whole processing volumes were 6.7 thousand barrels per day compared to 7.8 thousand barrels per day last year and were impacted by a customer compression upset that curtailed their gas flow into our system for most of the quarter. The average NGL barrel composition became heavier in the third quarter and contributed to an increase in our average keep-whole fee per barrel.

Fee-based processing volumes were 625,000 MMBtus per day compared to 767,000 MMBtus per day last year, which declined in line with our gathering volumes. Shifting to terminalling and transportation, we would like to highlight that throughputs and earnings were both records this quarter.

Segment operating income grew 67% year on year from \$51 million to \$85 million. Segment EBITDA grew 49% from \$69 million to \$103 million. Much of the improvement in our financial results reflects the storage revenues relating to the acquisitions of the Los Angeles storage and pipeline assets in the fourth quarter of 2015 and the Alaska storage and terminalling assets this quarter.

We reported record terminalling throughput of approximately 1.023 million barrels per day compared to 964,000 barrels per day last year. We saw increased demand at both our marine and marketing terminals supported by continued strong consumer demand fundamentals and refinery utilization.

Transportation volumes were a record 908,000 barrels per day versus 838,000 barrels per day last year. Contributing to this was our highest ever quarterly throughput on the Northwest Product System as well as higher activity on our Southern California system.

During the coming quarter, we expect to complete expansions of our Mandan, North Dakota and Kenai, Alaska terminals. Regarding capital expenditures, in the third quarter we spent \$37 million net of reimbursements. This includes \$26 million of growth capital and \$11 million of maintenance capital.

We expect total capital expenditures for the year to be \$170 million, with growth capital expected to be \$140 million and net maintenance capital expected to be \$30 million. The reduction reflects continued impacts from lower producer activity on the gathering side as well as spend that has been moved into 2017.

We are also seeing significant cost savings on several projects that are contributing to the lower totals. Looking ahead, you can find details of our volume expectations and other elements relating to our fourth-quarter outlook in our earnings release issued yesterday. With that, I will turn the call over to Greg.

Greg Goff - *Tesoro Logistics LP - Chairman and CEO*

Thank you, Phil, and good morning, everyone. During the quarter we highlighted the effectiveness of our strategy to grow the business through strong operational execution, organic growth from our existing assets, and strategic acquisitions. We had a number of meaningful achievements along the way to delivering record net earnings and EBITDA.

First, we completed the acquisition of the Alaska storage and terminalling assets from Tesoro. As we pointed out, these assets increased our full-service offering Alaska and improved our ability to serve our customers in the interior of the state.

In the terminalling and transportation segment, we reached record throughput in revenues in both the terminalling and pipeline transportation businesses. The record pipeline transportation throughput was supported by continued strength in demand fundamentals as US gasoline demand increased 3% year over year through September, and vehicle miles traveled increased 3.2% in the US and 4.8% in California year over year through August.

The year-over-year growth in the business enabled the 22nd consecutive quarter of distribution growth for our unitholders. With regards to our outlook, I would like to mention a few key items. On October 14, S&P upgraded TLLP's credit rating to BB plus with a stable outlook from the previous rating of BB.

This rating of BB plus is now the same rating as Tesoro's and is one notch away from investment grade. During the fourth quarter we expect Tesoro to offer the Northern California terminalling and storage assets, which we expect to add an estimated \$28 million to \$33 million of annual net earnings and \$45 million to \$50 million of annual EBITDA.

For the year, we now project the business will deliver \$345 million to \$365 million of net earnings and \$710 million to \$730 million of EBITDA, adjusted for the full-year impact of the RGS deconsolidation. This includes contributions from the Alaska storage and terminalling assets completed in the third quarter, but excludes any contributions from the potential acquisition of Northern California terminalling and storage assets.

We also expect to achieve 17% annual distribution growth in 2016. Looking forward to 2017, we are focused on growing TLLP's business across the western US and achieving our target of \$630 million of net earnings and \$1 billion of EBITDA by the end of the year.

Over the last five years, we have significantly grown our logistics business for TLLP. As we look forward with our strategy to continue that growth, we will also look for ways to optimize TLLP's cost of capital. Our strategy remains to grow earnings and distributions to unitholders through organic investments, strategic acquisitions, and acquisitions from Tesoro.



We are looking forward to updating you further on our plans and strategic outlook at our investor day event on December 6 in New York City. With that, we will take your questions. Operator?

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from the line of Shneur Gershuni with UBS. Your line is now open.

Evan Barbosa - *Tesoro Logistics LP - IR Manager*

Shneur?

Jennifer Hills - *UBS - Analyst*

I'm sorry about that, this is Jennifer Hills for Shneur. Shneur's question is are you reviewing the cost of capital for Tesoro Logistics, and will this review be concluded by the upcoming analyst day?

Secondly, what options would you consider? Would an IDR reset be the path, or would you consider a buy-in?

Steven Sterin - *Tesoro Logistics LP - CFO*

Good morning, it's Steven Sterin. As we stated earlier on the Tesoro call, you can also refer back to that as well, as we look at the future growth of TLLP we continue to see substantial opportunity both in organic growth, growth through acquisition, potentially adjacent basins to where we operate today, as well as continued dropdowns.

Access to appropriately priced low cost of capital that provides both that low cost with significant accretion opportunities for LP unitholders is absolutely critical to our long-term strategy. Clearly understand the impact of IDRs and how that impacts LP unitholders over time, and we'll continue to evaluate a whole host of options as we have discussed in the past to find ways to be able to accomplish all those objectives that I just stated. So at this point I wouldn't comment on something for investor day or specific timing, but be well aware that we're very aware of cost of capital and the different options that we have in front of us.

Jennifer Hills - *UBS - Analyst*

Okay. That's it. Thank you.

Operator

Our next question comes from the line of Jeremy Tonet with JPMorgan. Your line is now open.



Jeremy Tonet - *JPMorgan - Analyst*

Good afternoon. Just wanted to follow up on that last question. Just wondering, MPLX has made some announcements with MPC in conjunction with regards to the incented distribution rights. Just wondering if those type of objectives, what they were looking to do as far as lowering the cost of capital and also better highlighting the GP value for the parent, how you are thinking about the key priorities in this process or any other thoughts you can share there?

Steven Sterin - *Tesoro Logistics LP - CFO*

Let's see. First, our priority is growing the business and doing it in a way that's highly accretive and value accretive for our unitholders. And so behind that priority I would just answer the question about acknowledging the IDR impact on that. At this point I wouldn't comment on the GP.

That's an important part of Tesoro. What's important is making sure that access to capital and accretion to unitholders and availability of capital to support the growth going forward is our primary priority. Because ultimately that's where the most value creation comes to unitholders.

Jeremy Tonet - *JPMorgan - Analyst*

Great. Thanks for that. And then just wondering, within the Rockies, it seems like in the Pinedale some of the acreage there could be changing hands, potentially some of your producers as well. Just wondering any thoughts you might have on rotation among E&Ps in your footprint, and could this have a positive impact on your volume outlook there?

Phil Anderson - *Tesoro Logistics LP - President*

Sure, Jeremy, this is Phil. The Pinedale is a very well established field, and one of the things we look at in all opportunities is who is developing that field and where are their capital priorities.

I think if somebody were to come in and buy those assets, my guess is it would be a high priority for them to continue the development of that field, and I think we would be there to support them that in endeavor to the extent we can. I think all things being equal, if we saw that change hands I think we would likely see that as a positive event.

Jeremy Tonet - *JPMorgan - Analyst*

Great, thanks. That's it for me.

Operator

Our next question comes from the line of Brian Zarahn with Mizuho.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

On third-quarter processing volumes, how much of an impact was the customer compression issue and was that resolved?

Phil Anderson - *Tesoro Logistics LP - President*

I would tell you that some of that was resolved. As far as the overall volumes go, it does account for a significant piece of it. I would also tell you we rejected more ethane during the quarter, and that's why our per barrel mix has gone up.



So at least for a good portion of the volumes there's no net margin impact. And then the compression issue was really the other half of that. They did restore a significant portion of that compression around quarter end, and that will be reflected going forward in the fourth quarter.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

Then given the commodity price environment and the reduction in your CapEx for this year, how do you think about supply push versus the demand pull organic opportunity set?

Phil Anderson - *Tesoro Logistics LP - President*

Yes, at this point I would tell you in our existing basins we're going to finish up the projects we've got in the Rockies that complete through next year. We have some smaller projects up in the Bakken. There continue to be ongoing discussions with producers around incremental gathering in both locations.

It's a matter of when do the economics support their moving forward in that organic growth, and we can't predict that. We have been building our portfolio of terminalling and transportation related projects.

It's a pretty good sized portfolio at this point. It's a matter of getting through a number of permitting processes to really get into the thick of that, really as we move into next year.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

And then last one for me, given the large cash position how do you intend to finance the Northern California drop down?

Phil Anderson - *Tesoro Logistics LP - President*

I think as far as the drop down goes, we would pursue our typical financing pattern of 10% of the consideration in equity to Tesoro and the balance would be drawn on our drop-down revolver. And then the cash really remains, in terms of our view, it's an option towards potential strategic growth and/or reducing leverage would be our second choice.

Brian Zarahn - *Mizuho Securities Co., Ltd. - Analyst*

Thanks, Phil.

Operator

Our next question comes from the line of Kristina Kazarian with Deutsche Bank.

Kristina Kazarian - *Deutsche Bank - Analyst*

Could you maybe walk me through a little more color on natural gas gathered volumes? Maybe just some guidance in terms of the breakdown by basin where we saw the volume declines? Anything there and expectations on trends would be great.



Phil Anderson - *Tesoro Logistics LP - President*

Hi, Kristina, this is Phil. So sequentially what we saw was an increase during the quarter in the Pinedale, and that was, as we had guided, there were a significant backlog of drilled and uncompleted wells that were completed during the summer months. And those wells have all mostly come on.

There's a few that will drag into the fourth quarter. But we did see a nice uptick out of the Pinedale around that activity. We saw Uinta volumes fall sequentially, and that really was driven by -- there was no drilling in Uinta, and again, we're really at the limits of our compression, which has necessitated the big Walker Hollow project which we actually completed here very recently.

And that supports forward drilling in the Red Wash area next year, which we currently expect. In the Vermillion, which is the smaller of the three sub-basins where we operate, volumes were essentially flat, but we do have a new rig that moved into that quarter -- sorry, into that area late in the quarter, and we expect to see wells coming in here during the fourth quarter off that basin. And we're also working on a compression project there which will continue into next year that will additionally support that drilling and help us extract more volumes out of that field.

Kristina Kazarian - *Deutsche Bank - Analyst*

Perfect. That was helpful. Another one is that there have been a lot of private players that have been in the news a lot more often recently in terms of asset packages that might be coming to market in basins historically we have talked about as attractive. Can you maybe touch on from both parts of the Tesoro complex how we think about willingness to look at those, and if I did does that come in at the same time as I'm having the conversation around TLLP's cost of capital and managing that?

Phil Anderson - *Tesoro Logistics LP - President*

So I will start with the first part of the question which is what's our appetite in various basins. As Steven discussed, we are absolutely looking at all of the gathering areas in the western US, and that does include Permian Basin.

We think that fits Tesoro's long-term strategic focus area, and we will look at opportunities there to the extent we do see a number of systems under development, both by private equity and by producers that could very well come to market in the future. And I think as we think about that strategic growth, as well as other strategic growth in our footprint in the terminalling and transportation space as well, our anticipation is that the capital markets will be available and that TLLP units will be an attractive opportunity for investors to buy into the future. So all of those thoughts absolutely do exist in the same time and space for us.

Kristina Kazarian - *Deutsche Bank - Analyst*

Perfect. Last one from me, I know the analyst day is upcoming, so I don't mean to front run you if this is a topic there, but can you maybe just talk on how you think about the balance between growth versus coverage at least in theory?

Phil Anderson - *Tesoro Logistics LP - President*

So I would tell you the business strategy is to grow the business through attractive acquisitions and organic growth. That has absolutely been our priority from day one. It's to go capture new EBITDA overall within the Tesoro system, and that remains our number one priority.

In terms of our overall corporate strategy, or how we organize around the MLP, we've always had a target coverage of 1.1. We think that's where it's a prudent place to be.

I think to the extent we saw the opportunity to grow coverage over time and retain more cash and put it to work on attractive opportunities in the business, we would do that, all while maintaining a competitive growth rate on our distribution. So it's absolutely a balance that we look at all the time.

Kristina Kazarian - *Deutsche Bank - Analyst*

Perfect. Thank you.

Operator

Our next question comes from the line of TJ Schultz with RBC Capital Markets. Your line is now open.

TJ Schultz - *RBC Capital Markets - Analyst*

Great, thanks. How much EBITDA is available for drop down following the expected drop this quarter? And then if you could provide some color on the assumptions to hit that \$1 billion of EBITDA by the end of next year, both expected levels of dropdowns in 2017, potential other M&A, and maybe high level commodity assumptions that would base the expectations for producer activities in the Rockies?

Phil Anderson - *Tesoro Logistics LP - President*

Sure. I will start with the first part of that which is really the drop-down inventory. If you go back to last year's analyst day, we outlined a portfolio of drop EBITDA that exists at Tesoro that was between \$500 million and \$800 million, including a number of opportunities under development. If you look at where we expect to be with our dropdowns this year, it's somewhere in the \$80 million to \$100 million of EBITDA out of that portfolio that will have been dropped.

I think we typically would update that portfolio around analyst day. Obviously Tesoro is not a static organization, and we work hard to restock that opportunity set every year. And we will assess that and talk about it at next year's analyst day.

But I think, as Greg said on the Tesoro call earlier this morning, he would not see that portfolio coming down other than the drops we've done this year. On the second question in terms of bridging to the \$1 billion, I think we've always seen a number of opportunities with our strategy to get there.

I think specifically in terms of targets and plans for next year, we continue to see a couple of different ways to get to our objective. And again, we would rather focus that discussion at analyst day in the overall context of everything that's going on at Tesoro where we think it makes the most sense.

TJ Schultz - *RBC Capital Markets - Analyst*

Okay. Understood. And Phil, you mentioned some lower costs around CapEx savings, I think. If you could just expand on that, where you are realizing savings and what level of potential impact to returns on some of your projects?

Phil Anderson - *Tesoro Logistics LP - President*

Where we've seen -- there's a number of projects, specifically around our interconnects in the Bakken, where previously -- and those projects were probably scoped nine months or even a year ago. As we got into the execution and you actually order steel or relative to getting the crews in the field, both availability of labor has improved as well as lower actualized costs for pipe and pumps and things like that than we had previously estimated.

So relative to returns, it's obviously -- it's a help in that regard. But we've seen a couple of selected projects from a cost basis improve 10% to 15% to almost 20%.

TJ Schultz - *RBC Capital Markets - Analyst*

Okay. Thank you.

Operator

We have time for one more question. This question comes from the line of Ryan Levine with Citi. Your line is now open.

Ryan Levine - *Citigroup - Analyst*

Hi. Just to follow up on the distribution coverage questions, given your comment around 1.1 times coverage, do you view that's likely to evolve over time as your business changes?

Phil Anderson - *Tesoro Logistics LP - President*

I would tell you at this point if it evolves our view is we would like to move higher over time. We think 1.1, again, it provides the safety and security to ensure that the distribution is covered well.

It gives us head room for unexpected events and gives us the ability to adjust our path if we needed to. So I would tell you I don't think we see it going lower at any point in the future at this point.

Ryan Levine - *Citigroup - Analyst*

Okay. And then would you be able to quantify the financial and volume impact of the customer compression upset in Q3? And then I believe you mentioned that most of it was resolved by quarter end. Is there any way to quantify the portion that was not?

Phil Anderson - *Tesoro Logistics LP - President*

We haven't called it out, and since it is not our -- certainly it's part of our variance and our volumes, but I wouldn't want to direct it to an individual customer. But it is a significant part of the volume variance that you see, particularly in the keep-whole processing.

Ryan Levine - *Citigroup - Analyst*

Thank you.

Operator

And that concludes today's question-and-answer session. Ladies and gentlemen, thank you for your participation in today's conference. This concludes the program and you may now disconnect. Everyone have a great day.



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