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TSO - Q2 2017 Andeavor Earnings Call

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OVERVIEW:

Co. reported 2Q17 earnings of $40m or $0.31 per diluted share.

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PRESENTATION

Operator

Good day, ladies and gentlemen, and welcome to the Second Quarter 2017 Andeavor Earnings Conference Call (Operator Instructions)

As a reminder, this call is being recorded.

I would now like to introduce your host for today's conference, Mr. Brian Randecker, Investor Relations. 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 second quarter 2017 earnings.

Joining me today are Greg Goff, Chairman and CEO; and Steven Sterin, Executive Vice President and CFO.

The earnings release, which can be found on our 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.

Now I'll turn the call over to Greg.

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

Good morning, and thank you for joining us today.

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On August 1, we formally changed our name to Andeavor and our logistics company to Andeavor Logistics. We believe that the name Andeavor and Andeavor's Logistic are part of a distinct identity that supports our creation of a premier highly-integrated marketing logistics and refining company. We believed we reached the tipping point in our journey to grow and develop the company that created an opportunity to make the change. We are excited about our future and the opportunity to create a special identity. Our commitment to our people, our shareholders, our customers, our business partners and our community is to improve everything that we do. These improvements, combined with transformative strategic actions are critical to creating a premier company.

Now turning to the performance of Andeavor during the second quarter. Our results for the quarter were strong, driven by contributions from our highly-integrated business model, continued execution of improvements to operating income and a contribution from the Western acquisition. Overall, the company is performing well and we are optimistic about our outlook and the opportunities for the remainder of 2017.

First, I would like to comment on our acquisition of Western Refining. As you know, on June 1, 2017, we closed a $5.8 billion acquisition. The initial integration efforts have been very successful, and we are rapidly moving forward to fully integrate the business. After a little bit more than 60 days, we remain confident in delivering an expected $350 million to $425 million in annual run rate synergies by June of 2019. 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. We provided more detail about the synergies on June 1, and those comments are still relevant.

As of August 8, we estimate we have achieved approximately $80 million in annual run rate synergies, consisting of approximately $70 million of corporate efficiencies and the remainder in value chain optimization and operational improvements. The company also realized approximately $115 million in onetime cash benefits as part of the acquisition, primarily due to the return of cash collateral held by Western Refining suppliers due to the stronger credit profile of Andeavor.

We also achieved several significant milestones during and shortly after the quarter, including receiving the permits and beginning construction of both the Los Angeles Integration and Compliance and Anacortes Isomerization projects, acquiring 39 high-quality convenience stores in Northern California, commencing business in Mexico and forming a joint venture with EP Energy to produce waxy crude oil in the Uinta Basin to supply the Salt Lake City Refinery with advantaged crude oil.

Turning to our operations for the quarter. First, within marketing. Andeavor is committed to driving growth and improvements in its marketing business by focusing on high-value branded distribution channels, adding new retail sites to the network and implementing store improvements to enhance the company's convenience store position. We believe that the changes we made to our reporting for our marketing segment should give you a better understanding of our business and better ability to compare our marketing business to other industry peers.

Marketing margins were $0.232 per gallon for the retail and branded channel. PADD 5 market conditions remain strong, driven by about 2% demand growth year-on-year through April.

We are pleased to announce that in July, we closed the acquisition of 39 high-quality convenience stores primarily in Northern California. We expect the sites to contribute $10 million of annual net earnings and about $25 million of annual EBITDA. The acquisition reflects a multiple of approximately 7x EBITDA. This will further strengthen our integrated business by expanding our retail presence in Northern California by adding approximately 6,000 barrels per day of branded sales.

As we discussed last quarter, Mexico was the newest growth initiative for the marketing business. We announced earlier in July that we signed a terminalling and transportation services agreement with Pemex, which allows for the potential for us to supply 30,000 to 40,000 barrels per day of transportation fuels in the states of Sonora and Baja, California, Mexico. We also recently announced, we signed a wholesale supply agreement to begin marketing operations using the ARCO brand. We expect the first stores to open within the next 60 days. We believe these agreements support the company's integrated value chain by extending the marketing presence into the growing market in Mexico. We will continue to grow our integrated footprint, and the company expects to increase its marketing presence across the entire northern part of Mexico over the next few years.

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Moving to Logistics. We had solid results for the quarter, led by higher-than-expected volumes in terminalling and transportation driven by strong demand in our market area. Gathering and processing was negatively impacted by slower completion activity and the extended planned maintenance at our Mandan refinery. We are seeing improved volumes going into the third quarter driven by more drilling activity and minimal planned maintenance at Andeavor's refineries. In addition, the Andeavor board has authorized management to work with the board and management of Andeavor Logistics to consider and begin to negotiate a merger of Andeavor Logistics and Western Logistics and changes to the capital structure of Andeavor Logistics with respect to the incentive distribution rights. After evaluating many options related to the incentive distribution rights, both Andeavor and Andeavor Logistics preferred approach is to pursue a buy-in transaction in exchange for common units. The transactions require approval of the Board of Directors of all 3 companies as well as the conflicts committees of both MLPs. We believe we will be able to complete negotiations and announce the transaction during this quarter. We expect the opportunity for Andeavor Logistics to acquire assets offered by Andeavor in the fourth quarter of 2017, which could add an additional $30 million to $40 million of annual earnings and $45 million to $55 million of annual EBITDA. Given the timing for this expected drop down, we expect Andeavor Logistics to achieve its run rate target of $525 million of annual net earnings and $1 billion of annual EBITDA for 2017. With more stable market conditions and the possibilities to improve Andeavor Logistics' competitive position, we remain excited about our future and the ability to grow value for our unitholders.

Now shifting to refining. Total refining throughput was 893,000 barrels per day or 91% utilization. Gross refining margin was $9.45 per barrel. We had good operating performance during the quarter, and throughput was in line with our expectations. We have minimal planned maintenance for the remainder of 2017 and expect strong utilization for all of our assets.

We recently received the permits for our Los Angeles Refinery Integration and Compliance Project, which is often referred to as LARIC and have commenced construction on the project. This project enhances our position on the West Coast and offers several benefits that include: first, the full integration of a Carson and Wilmington operations; second, yield flexibility of 30,000 to 40,000 barrels per day between gasoline and distillates; and third, a significant reduction in greenhouse gas and other criteria pollutant emissions. The company expects the project to generate $65 million of net earnings and $125 million of annual EBITDA and will be fully completed in 2019. This multistage project will have many aspects that start prior to 2019. We were actually able to increase rates from 55,000 barrels per day to 60,000 barrels per day on 1 of our Hydro crackers, the data permit was issued, which allows us to begin realizing immediate benefits from the project. The 2 large elements of the project are decommissioning the fluid catalytic cracking unit, or FCCU, and the construction of the Los Angeles refinery interconnect pipeline system. We expect to decommission the FCCU by year-end 2018 and the pipeline bundle which further connects both portions of the Los Angeles refining complex is expected to be completed in mid-2018. With the permits and commencement of construction on the pipeline interconnect system, we have started working with Andeavor Logistics to have the MLP acquire this portion of the project.

We also received the permits related to the environmental impact statement for the Clean Products Upgrade Project in Anacortes, Washington. The Isomerization project is now fully permitted and has commenced construction. We expect this project to be completed in the second quarter of 2018 that will generate approximately $20 million of net earnings and $40 million of annual EBITDA. The Mixed Xylenes Project has also obtained its EIS permit and can now move forward in obtaining the remaining permits necessary to begin construction. We expect to make a final investment decision on this project at the beginning of 2018.

During the quarter, Andeavor announced the formation of a drilling joint venture with EP Energy Corporation. This multiyear program will fund the development of 60 wells, which are expected to produce waxy crude oil and natural gas in the Uinta Basin of Utah. The agreement allows the company to secure additional supply of the advantaged black and yellow waxy crude oil to optimize the operations of the Salt Lake City Refinery. As part of the agreement, the company also secured additional waxy crude oil supply produced from EP Energy's existing production. This was a unique opportunity for the company to secure additional waxy crude oil supply at a competitive price. We may look at other similar unique opportunities in the future but we do not expect company will invest heavily in crude oil production.

Andeavor also received a grant from the North Dakota Industrial Commission to support a project to begin processing renewable feedstocks into diesel. The project will allow the Dickinson Refinery to retrofit the existing diesel hydro treater to be able to co-pross (sic) [co-process] up to 5% per day of renewable feedstocks such as vegetable, corn or soybean oils while continuing to process Bakken crude oil. The project is expected to begin production at the beginning of 2018.

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Moving to our outlook for 2017. Our expectations for the year are unchanged from our last update a few months ago. These include the following marketing assumptions -- market assumptions. An Andeavor index of $0.12 to $0.14 per barrel and marketing segment fuel margins $0.11 to $0.14 per gallon. Additionally, we are 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. I would like to point out that these estimates do not include any expected synergies from the Western acquisition.

Our improvements to operating income for 2017 consist of $305 million to $355 million in refining, $125 million $150 million in Logistics and $45 million to $70 million in marketing. Through the first half of the year, the company has delivered approximately 50% to 55% of these improvements, which is generally where we expect to be at this point in the year. Estimated marketing and logistics improvements are trending above their ranges. However, estimated refining improvements are trending slightly below the range.

I would like to acknowledge the excellent work of our people. We are working hard and executing extremely well to deliver the plans and improvements I have outlined. Our employees continue to deliver results, drive towards being the safest and most environmentally responsible operator in the industry, execute major projects and position the company to continue to grow and create value.

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

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

Thanks, Greg. Yesterday, we reported Andeavor's second quarter 2017 earnings of $40 million or $0.31 per diluted share compared to $418 million or $3.47 per diluted share a year ago.

Consolidated net earnings were $87 million for the second quarter compared to $449 million for the same period last year. And EBITDA was $470 million, compared to $956 million last year.

Second quarter 2017 results included $313 million of pretax charges, including a pretax expense of $209 million related to a lower cost or market or LCM inventory adjustment. Pretax acquisition and integration costs of $124 million related to the Western Refining acquisition and a net pretax gain of $20 million related to Andeavor Logistics. Additionally, we incurred higher tax expense of $12 million related to some of the aforementioned acquisition cost not being deductible. Second quarter 2016 results include a pretax benefit of $363 million related to an LCM inventory adjustment.

Western's business has operated as expected in the first month of ownership. The business recorded a net loss of $32 million and negative $30 million of EBITDA for the 1 month of operations during the quarter. These results include $116 million of pretax charges, which include a pretax expense of $43 million related to an LCM inventory adjustment, pretax acquisition integration cost including severance of $73 million related to the acquisition, and additional tax expense of $3 million related to nondeductible acquisition costs incurred directly by Western. The effective tax rate for the second quarter of 2017 was 39.2%. The effective tax rate was higher than our historical rate, primarily driven by the additional tax expense of $12 million related to nondeductible acquisition costs.

Moving to our business segments. In marketing, let me start out by saying, beginning this quarter, we provided additional analytical information about our marketing and business, including separate volumes and fuel margins for retail and branded operations as well as unbranded operations, merchandise margin and store count. This should give you a better understanding of our business and the ability to better compare our marketing business to other industry peers, which we believe helps underscore the significant intrinsic value of our integrated portfolio.

Marketing segment operating income was $236 million, segment EBITDA was $250 million and fuel margins were $0.134 per gallon for the second quarter 2017 versus segment operating income of $161 million, EBITDA of $173 million and fuel margins of $0.105 per gallon a year ago. Retail and branded fuel margins improved to $0.232 per gallon from $0.198 per gallon in 2016, due to favorable market conditions driven by PADD 5 gasoline demand increasing 2% through May 2017.

Unbranded fuel margins were $0.031 per gallon compared to $0.07 cents per gallon last year also due to continued strong gasoline demand and improvements we've made to our customer portfolio.

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Merchandise gross margin increased to $20 million from $2 million in 2016, driven by the new stores we acquired as part of the Western acquisition. We continue to see strong demand growth in our regions and continue to expect our fuel margins to be $0.11 to $0.14 per gallon for 2017.

Shifting to Logistics. Segment operating income increased to $167 million in the second quarter from $118 million a year ago, and segment EBITDA grew to $238 million from $167 million last year. The results include a $25 million net gain related to the successful sale of an Alaska terminal with 209,000 barrels refined product capacity, which the company was required to divest following the Alaska storage and terminalling assets acquisition completed in 2016. Results also included a $5 million negative impact related to the settlement of a customer contract dispute and $2 million of acquisition-related cost. Also impacting this business in the quarter was the extended duration of the Mandan full site turnaround, which had a negative impact of $9 million in the quarter due to lower volumes and higher maintenance cost.

The increase in segment operating income and segment EBITDA were primarily driven by contributions from the North Dakota Gathering and Processing Assets acquisition completed in the first quarter of this year, strong refinery utilization and product demand generating higher throughput at our California Marine terminals and contributions from the Northern California Terminalling and Storage Assets and Alaska Storage and Terminalling Assets drop downs completed in 2016. Results also benefited from 1 month of contribution from WNRL's operations.

The total general partner and limited partner distributions received by Andeavor were $71 million during the second quarter. This is an increase of $12 million from a year ago.

Turning to refining. Segment operating income was $45 million for the second quarter compared to $527 million a year ago, and segment EBITDA was $206 million versus $697 million last year. The Tesoro index was $14.70 a barrel for the second quarter with a gross refining margin of $768 million or $9.45 a barrel. This compares to the Tesoro index of $13.93 per barrel and a gross refining margin of $1.1 billion or $15.70 per barrel last year. But when comparing our second quarter 2017 segment operating income, segment EBITDA and gross refining margins to the same period last year, please keep in mind the results in the second quarter 2017 include a pretax expense due to the LCM valuation adjustment of $209 million or an approximate $2.60 decrease to gross margin on a per throughput barrel basis. And results in the second quarter 2016 included a pretax benefit related to LCM of $363 million or an approximate $5 increase to gross margin on a per throughput barrel basis. So other than the LCM impacts in both quarters, the significant year-over-year increase in gross refining margin reflects stronger refining crack spreads, the continued delivery of improvements to operating income and contributions from the Western acquisition.

Total refining throughput for the quarter was 893,000 barrels per day or 91% utilization. Consolidated manufacturing cost for the second quarter were $5.67 a barrel, driven higher by increased energy cost and timing and maintenance expenses.

In our California region, throughput was in line with our expectations. We're able to optimize around our planned turnaround in Martinez to capture the higher-margin environment caused by strong demand and unplanned outages during the quarter. Other than the LCM impact in both quarters, the year-over-year increase in California gross refining margin was driven by stronger refining crack spreads, higher throughput and continued improvements in our assets.

In our Pacific Northwest region, throughput was at the high-end of our expectations. However, gross refining margin was impacted by unplanned downtime at our Anacortes refinery, which is now resolved.

In the Mid-Continent region, throughput was higher than our expectation, driven by the additional 88,000 barrels per day of throughput from the El Paso, Gallup and St. Paul Park refineries. However, our Mandan facility underwent a 7-year cycle of full site turnaround. With the exception of the third-party power interruption causing the turnaround to begin earlier than planned, the site did an excellent job for the turnaround in June.

Now let me take a moment to discuss our balance sheet, cash flow and our strategic priorities for creating long-term shareholder value. During the quarter, Andeavor achieved an investment-grade credit rating. In June, S&P Global Ratings raised our corporate credit and senior unsecured issue ratings to triple B minus with the stable outlook from double B plus. Fitch had already upgraded both Andeavor and Andeavor Logistics to investment grade in February. Additionally, in July, Moody's Investor Services upgraded Andeavor to investment grade, raising its senior unsecured rating to be BAA3 from BA1. Andeavor now has an investment-grade credit rating from all 3 rating agencies. As a result of a Andeavor achieving a BBB minus credit rating at both S&P and Fitch, our outstanding unsecured bond securities now meet the criteria to be included in the investment-grade

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Bloomberg Barclays Global Aggregate Index. Our balance sheet and credit metrics remain strong. We ended the quarter with a consolidated cash balance of $1.1 billion. This was down from $3.3 billion at the end of last year primarily due to the Western acquisition and Andeavor Logistics' acquisition of the North Dakota Gathering and Processing Assets.

Total debt, net of unamortized issuance cost was $7.6 billion or 38% of total capitalization at the end of the quarter. Excluding Andeavor Logistics and WNRL, debt and equity total debt was $3.5 billion or 28% of total capitalization.

Andeavor generated cash flow from operating activities of $670 million in the second quarter.

During the second quarter, we invested $78 million in high-return growth capital projects at Andeavor, Andeavor Logistics and WNRL. Our combined capital expenditures, including income capital, sustaining, maintenance and a month of capital for Western assets was approximately $267 million consisting of $218 million for Andeavor, $45 million for Andeavor Logistics and $4 million for Western Logistics for the month of June.

We repurchased 1.6 million shares for approximately $148 million in the second quarter and had approximately 2 billion remaining under our approved share repurchase programs as of June 30. Additionally, we paid pay dividends of $65 million and Andeavor Logistics distributed $69 million to its public unitholders during the quarter.

As of August 8, 2017, the company has executed approximately 4.2 million of share repurchases for approximately $400 million, and has $1.7 billion remaining under its previously approved share repurchase programs. As stated before, our cash generation positions us to continue to invest for growth, maintain a strong investment-grade balance sheet and continue repurchasing shares under this authorization. And we intend to do so throughout the rest of this year.

We announced yesterday the Board of Directors approved to increase the quarterly cash dividend by 7.3% to $0.59 per share each quarter, payable on September 15, 2017, to all holders of record as of August 31, 2017. As Greg mentioned, we believe there is significant value in Andeavor's ownership and Andeavor Logistics. In particular, the incentive distribution rights, which we believe is a source of tremendous intrinsic value for Andeavor shareholders.

Our financial discipline and principles remain unchanged, and helped guide us as we evaluated options for the merger and the IDR buy in. These principles include the following: achieve an attractive cost of capital by removing the IDR burden and merge the MLPs to achieve near-term cash flow accretion, which allows, ANDX to aggressively grow the business; immediately increase and sustain a coverage ratio of around 1.1x; maintain debt-to-EBITDA below 4x and achieve an investment-grade credit rating in the near term; sustain an attractive and competitive long-term distribution growth rate; significantly reduce new public equity issuances needed to achieve growth resulting in more value creation and less dilution for unitholders; and to ensure Andeavor shareholders realize the intrinsic value from ownership of this attractive and growing Logistics business. As we progress through this process, we will share more details in appropriate time so we feel this is a very important part of Andeavor's full valuation potential.

Turning to our 2017 capital outlook. We anticipate full year 2017 capital expenditures to remain unchanged at approximately $1.35 billion, consisting of $1 billion of Andeavor, $325 million at Andeavor Logistics and $25 million at WNRL.

Expected turnaround cash expenditures for the full year 2017 were $360 million. Including Western, they are now expected to be $485 million.

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

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

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QUESTIONS AND ANSWERS

Operator

(Operator Instructions) And our first question comes from Phil Gresh with JPMorgan.

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

The first question would just be in the back of your press release, you give some numbers for Andeavor Logistics, marketing, et cetera. And for marketing, you talked about $1 billion of projected-segment EBITDA. It didn't give a specific time frame for that. I think in the past, maybe you've talked about 2018, but I was curious given the second quarter performance basically was run rate in there. Is that a 2017 target at this point?

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

Yes, Phil. Originally, our target was to achieve $1 billion of the EBITDA for our marketing business by calendar year 2018. And now with the acquisition of Western in that business, it brings it forward to this year.

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

Got it, okay. Second question would just be on this IDR buy in. I know you probably don't want to say too much here. But I just want to take a stab at it in terms of -- If you look at the targets for EBITDA at Andeavor Logistics, if you think about the drop-down you are targeting some of the growth projects, et cetera. Is there kind of frame of reference you can give us for what range of GP IDRs we'd be talking about in 2018 upon which this would be based? And obviously, some peers have been out there publicly with ranges and they've talked about it 15 to 20x of the ranges they've given. But really any kind of color you might be able to give here would be helpful.

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

Yes. This is Steven, Phil. Because of the fact that we're in negotiations with really 3 public companies, as you know, we're limited in what we can say. And given the fact that we're contemplating both a merger and IDR buy ins. I can't at this time tell you what the forward combined IDR distributions would be. We'll, of course, do that at the right time. I think the key thing to keep in mind is what we're trying to achieve and hopefully, when we present that to you, you'll see it being very, very consistent with the principles I just outlined for you.

Operator

And our next version comes from the line of Paul Cheng with Barclays.

Yim Chuen Cheng - *Barclays PLC, Research Division - MD and Senior Analyst*

I have 2 questions and a request. The request is that if possible, it would be great, if you can break out the Southwest region from the Mid-Con because I think the refining dynamic is quite different between your Rocky Mountain system and your Southwest. And also it seems that you're looking at your Logistic, just basically between the South and North. It seems like that's more logical. In terms of the question. Greg, on marketing, what is the future strategy? When you're looking at your 3 different channels, you have to co-op, you have the on-site and then franchisees operating and (inaudible) . When we're looking forward that, which channel you're going to be the major growth focus for you? Or that it -- with it as you're going to focus all of them at the same time? And also debt -- with the debt, why now because that a lot of your operation is full multiple acquisition so you have many different brands in maybe even within the same region. Is that a brand strategy going forward? Or that this is you're comfortable continue to do that? And also that whether with all these acquisition, why now you're in a pawn? You have the single IT management and accounting

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platform and say that or that this is something that you need to work on. And then on the marketing, that you have a lot of investor arguing that maybe better off than to spend it off because it's much higher value. Just want to see what is your approach on that question?

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

So how many questions did you ask, Paul?

Yim Chuen Cheng - *Barclays PLC, Research Division - MD and Senior Analyst*

That's all related to marketing.

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

No, that's fine. Let me just take a step back and talk about our marketing business and hopefully addressed most of your questions. So first, I mean, the marketing business is such an integral part of our value chain because we, in most places, physically deliver product to our marketing businesses because our integration is so close to our refining assets. I think that's an important thing. Second, we believe that from a approach to the market, when you look at the different channels to address one of the points you raised, that having a portfolio approach of different ways to go to the market whether it be through company owned and operated or through wholesale branded and even sometimes through unbranded that, that is the best approach. And what we try to do is to look at that particular geographic area and kind of meet the needs of the customers in that place. And therefore, we have that portfolio, which is different in each of the different regions when you -- if you'd look at closely at our business. So that's the second thing. The third thing is that we want to continue to drive improvements and capture opportunities in the marketing business. So we will continue to enhance the operations by the quality of the outlets that we have. We'll continue to build on our convenience store offering to capture a greater percentage of the convenience store offering. We believe that's an excellent opportunity for the future of our business. We do like having brands that are targeted to each of those areas. It is our intentions to maybe streamline the brand focus but we do not intend to minimize the brands that we have and focus on just a couple of brands. So we will -- we believe that we have high-quality brands in specific market areas that serve the customers best there, and our intentions are to keep performing that way. So we see an opportunity to do some selected growth like we just announced in the Northern California area. That was a good fit for our business. We can physically supply those stations. We can brand those stations to fit in our area there, which is primarily the Mobil brand and we'll continue to look for those opportunities to grow the business that way. It is our intentions to continue to enhance the profitability of our overall marketing business, which also includes now expanding our marketing business into Northern Mexico, which we see is just a continuation from our operations both in the Southern part of California and into the future going down out of the El Paso refinery. And then finally, your last question about the valuation. We see tremendous value in our integrated business between refining, marketing and logistics. And we believe that we capture the most value for our shareholders by really optimizing that integrated value chain and getting high performance out of refining, logistics and marketing individually.

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

And you also asked the question, Paul, about accounting and information systems. Andeavor has been working for the last 18 months or so on putting in a new fully-integrated transaction system and analytical platform. And we're on the final stages of that. That goes live in just the next couple of months. And we'll be -- that gives us -- and it was always the intent, the ability to scale and bring acquisitions onto our platform rapidly. And so our intent would be to and we're already working in parallel, bring the Western systems onto this new standard Andeavor platform between now as we've already started and the first and second quarters of next year. And so we've got that work well underway, and it's critical to capture the rest of the synergies that are out there.

Operator

Our next question is from Justin Jenkins with Raymond James.

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

I guess, maybe if I could, start at a high level on the balance sheet. Things like with the buyback pace to start 3Q here that maybe the cash balance at that quarter-end of 2Q is maybe higher than you plan to manage it. Just curious as we sit today, what's the comfortable overall cash frames that we'd like to see? And maybe how you view the buyback in terms of being rateable versus opportunistic here?

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

Yes. Now that we've reached investment grade at Andeavor, it certainly gives us more flexibility. As we think about cash balance, we've got a $3 billion unsecured revolver. And so from a liquidity perspective, we have tremendous flexibility to be opportunistic whether that's making investments when there's -- the Capital Markets aren't attractive. Or repurchasing shares at times at accelerated pace because of the price of the stock will ratably over time. And so I would say that, I wouldn't just look at the cash balance or look at the overall liquidity position as the way we think about it. And now being the investment grade having tremendously more flexibility. But we are committed to executing our share repurchase programs that we have authorized. As we talked when we did the Western acquisition and we needed to issue equity to do that. We're committed to making sure that we set aside in our cash allocation an appropriate amount of cash buyback, a meaningful amount of shares. At that point it was a $2 billion program, which as you pointed out where we've begun executing that. I wouldn't expect it to be ratable, because we are thoughtful about being opportunistic and buying more times when the price is underperforming. But we do remain committed to being active. In our share repurchase program, we couldn't do the first 5 months of the year. And our commitment is to over an appropriate period of time have a balanced approach to the use of cash but to compete that share repurchase program in a meaningful time period.

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

Perfect, that's really helpful. And then I guess maybe switching gears to the LA integration project. Can we get a sense maybe of the proposed mix of spend between the corporate level and the MLP over time here?

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

I think what we've said in the past that the pipeline portion of it's somewhere between $175 million to $200 million and the rest of it is tied into the refining portion of the business.

Operator

Our next question is from Neil Mehta with Goldman Sachs.

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

First question is just related to the Western synergies. And I appreciate it's still early in the process and you've given us these 3 buckets that help frame out the opportunity in value optimization, operational improvements and corporate efficiencies. But could you peel back a little bit further and kind of give us some tangible examples across those 3 different buckets? And what gives you confidence and ability to execute within the range or maybe even above the range?

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

Neil, back in June, when we close the deal, we provided that specific information. We gave detail on each of those 3 buckets, as you just requested and that information hasn't changed. What gives us confidence in being able to deliver that level of synergies and more importantly, in the time frame that we stated because the -- doing it within a couple of years is fairly aggressive, is that as soon as we were able to -- as soon as we closed,

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we have an approach where we allow groups of people that have knowledge of that particular part of the business, whether it be the value chain or the refining operations or whatever, they got together, they took our preliminary ideas and they brainstormed and looked at all of the possibilities that we could achieve by the combination of the business. And through that process, which is completed -- through that process, not only was able to validate many of the things that were initially identified, they came up with lots of other ideas. I will say that there is no one big thing. So it is a lot of things that we have to deliver on, which actually is pretty good because we can spread that and capture that with a little bit more velocity than other things. But we're highly confident in everything. We validated them, and we have additional ideas to be able to deliver those synergies. So I didn't have with me that press release from June but if you go back in there, it details what the things that we're looking at.

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

Right, appreciate that, Greg. Follow up is just on Mexico. Just how big of a business do you think this can be for full Andeavor? Do you see this as a nice to have? Or as a major pillar that's key to driving your strategy going forward?

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

Yes. For the company, Neil, the nice thing about it is that it's continuous with the United States. And we have refining assets that are right on the borders -- the Los Angeles Refinery and the refinery in El Paso. So it's actually a natural extension of our value chain. And so we believe that as we've looked at the market area -- and at this stage, we focus much more on Northwest Mexico than we have coming out of the El Paso refinery just because of the time we've had since we closed the acquisition. But in the past, we've said that the targeted part of Northwest Mexico has a demand of about 160,000 barrels a day, 2/3 gasoline, 1/3 diesel and growing. And when you look at supplying that market, it's kind of a natural to come from our refining area. And the important part for us is to be able to take those volumes to the street through a distribution system that we have secure, comfortable, reliable supply through there. So I would say that over the next 5 years, we have a potential to pretty significantly grow our marketing presence, which would include retail stations, a wholesale business and a commercial business, which would include other products besides just traditional gasoline and diesel. And that as we get more into it, we've created an organization that will be partially based in Mexico and in the U.S. and be able to develop that and be able to talk very shortly about what we see the potential to be from an overall profitability standpoint. But it's going to take us 3 to 5 years to get to the point we want to get to.

Operator

Our next question is from Brad Heffern with RBC Capital Markets.

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

I'll try another question on the IDRs. I just wanted to verify that this is all going to be one transaction? So the merger and the IDRs would be announced at the same time? And additionally, I was wondering if there's any change in thinking around drop multiples once the MLP no longer has the IDR burden?

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

So directionally, you're thinking about it the right way. From a -- we said that all 3 companies have to approve what we're doing and ideally you'd like to do all those things in one time. So that would be the best outcome and that would be something we'd like to achieve. And second, in terms of drop down multiples. I think the way we've always described it and will be consistent with this is that we wanted to do it at a fair value. A value that is fair to both Andeavor as well as accretive to the Logistics business. The removal of the IDRs makes that a lot easier and more accretive, which we think can unlock -- can still get the high values that we should get to Andeavor but unlock more accretion with less unit issuance at the Logistics level, which should unlock more value in the units themselves, which we own a significant number of. And so that's how I think about it at this point. We'll continue to expand upon that.

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

Yes, and I would just add that drop downs are market-based. You have to understand the principle of a drop-down, its market base and in almost all cases, there are comparable values of what you can sell that asset for in the marketplace and the principle is to do that, like Steven said, what he called the fair equitable value is the market base value.

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

Okay. And then speaking with Steven. it looked like the revolver balance -- or revolver had a balance this quarter. It looked like maybe $600 million. Is that the right number? Or is that just -- as you were talking about before being strategic with the repurchase program?

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

No, it does have a balance of about $600 million and the main driver of that was the cash consideration portion of the acquisition as well as acquisition-related costs. That's something that we'll look at, now that we're investment-grade and you look at where our interest rates are. Whether you turn some of that out, you pay some of that down. But given how low cost the revolver is, we're comfortable with that being just part of the capital structure right now, but that's what the proceeds reads.

Operator

Our next question is from Blake Fernandez with Scotia Howard Weil.

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

I was also hoping to verify -- I was hoping to verify something on the IDRs as well. Are you contemplating any kind of potential just restructuring of the IDRs? Or are you only intending to fully retire them?

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

So that's what we wanted to be clear on and that's one area that although, we haven't gone to the complete approval process with our boards, in the process we have agreed that a full buy in -- so a permanent solution to the IDRs is the best approach for both Andeavor and Andeavor Logistics. Provides clarity and cost of capital and we think it provides the best intrinsic value for a marketable company. And so it would be a full buy in structure.

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

Okay, that make sense. And then, so I guess, post that transaction, assuming it comes to fruition and given the fact that you'll be taking units, you'll be quite a large shareholder Are you -- is the intention to just maintain that ownership in the LP for the foreseeable future? Or is there a liquidation event on the horizon at some point?

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

I'd say in general, the same thing that we've said. You're right, we will if you do the conversion, it will increase the number of LP units we have. You think that economically, we already have that type of ownership but it's just through a more complex instrument. But we like our ownership and we think it's a very attractive part of the value chain, as Greg mentioned earlier, and the intrinsic value clarity that comes with the elimination of

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IDRs. And we think -- we wanted -- it's a graphically growing business. It's got tremendous opportunities to continue to invest for growth and so we like that investment and we'll likely hold the units that we have.

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

Okay, and Steven, I'm sorry, if I could just slip in one last. Just a minor from a reporting standpoint. This JV in the Uinta. With the production associated with that, any kind of our earnings and the cash flow, is that simply going to be reported into the gross margin of the Mid-Con? Is that kind of the way that it's going to work?

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

Yes, that's exactly how it will work. It will show up in the cost of the advantaged crude that we were able to get as well as refining uplift. So gross margins in Mid-Continent.

Operator

Our next question comes from Corey Goldman with Jefferies.

Corey Benjamin Goldman - *Jefferies LLC, Research Division - Equity Analyst*

Just a follow-up, question related to Mexico. What type of returns are you targeting in that region? So we understand, obviously, a new geography affords you some diversity in incremental demand centers, but just curious on any additional risk premium you can talk to when considering those types of investments?

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

Yes, first of all, I mean we're going to take a portfolio approach and initially, our business will just be a brand -- ARCO branded wholesale business. So from that standpoint, we don't have a lot of capital tied up into the business. And so we'll get -- we think the margin environment will be somewhat comparable to what we have experienced in the United States. The -- over time, we will look to see if it makes sense to invest in company-operated stations in Mexico. And that's something we'll determine if that's a good thing for the company to do . And from that standpoint, I would suspect that the returns won't be materially different than what they are in the United States. I mean, from a marketing standpoint, we don't see that type of a risk that would justify any type of a risk profile. It would be different if you were in the refining business for that. But we see it just comparable to the rest of our marketing business.

Corey Benjamin Goldman - *Jefferies LLC, Research Division - Equity Analyst*

Great, that's really helpful. And just as a follow-up, sorry. I'm going to ask another question on the IDRs. Are you also including a drop-down to Andeavor Logistics with that? And then also with that, how do you treat the current Andeavor waivers in place as it relates to the transaction? Are you looking at pro forma IDRs ex-waivers? Or IDRs with waivers?

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

So the first question, in terms of drop downs, we have stated in our Andeavor Logistics release that we anticipate doing a drop down in the fourth quarter, which we said we'd like to have this transaction completed and announced in the third quarter. And so that would be the sequencing I would think about directionally. And your other question, think it's too early to answer but it is something that we will provide clarity to as we complete the transaction.

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Operator

The next question comes from 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*

Greg, I'm going to follow-up on Paul's 10 questions on retail, if I may. Just on the structure of the ownership structure, not necessarily of retail, as a stand-alone business, but more of the real estate ownership within Western's I guess, inherited assets, what are your thoughts there in terms of whether that's something that you could ultimately monetize? And I guess, maybe while you're on the top if you could address the issue of whether you think you're getting through value recognition for that retail business in the current structure?

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

Yes, I -- we haven't had enough time to really look at the real estate portfolio for the business that we just acquired as well as our own real estate portfolio. But it's something that we will continue to evaluate, Doug. Something that we need to look at and see what's the best use of the balance sheet for the company and getting them the optimum return on the assets on that. So it's just a little bit too soon for us to have a decision of what we're going to do there. And the second question is, when we look at the valuation of the company, we think the company in total is undervalued and we see the things that we're working on. And when -- we have a obligation to look at the valuation of the company and do everything we can to achieve that value in the marketplace. And so -- but that's always been the case. We've always felt like with what we're trying to do in the company and the opportunities from the improvements that we've identified, the capital investments that we're pursuing in the business to grow the profitability of the company in that. And we've always been chasing the true value of the company, and that's kind of a good thing. We'll continue to follow through and be able to do that, including the marketing business.

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

So the other one, I pushed it too hard on this, Greg, but obviously, integration is very important to you as you laid out in your prepared remarks in terms of marketing and logistics and refining. But would it be fair to say you're not ruling out the potential for a stand-alone retail listing, let's say? Is that off the table? Or is it something you would consider?

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

I mean, we look at everything. We pride ourselves actually on going after the business and creating value for the owners of the company, so we look at everything and we try to do it pretty much on a continuous basis. And so we'll always continue to look at it, but at this point in time, we see what we're doing in the value that we can create both individually and each of the segments as we talk about our business, refining, marketing and logistics as well as the collective combination of those businesses as being just full of opportunities. And so we'll just continue to look at it over time.

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

I know it's not an easy question to answer. My follow-up hopefully a little quicker is, I guess, first of all, congratulations on getting the 2 permits. It's been a long time coming as you know, I'm just wondering if the project scope has changed? And if how you've been waiting on those unspecific to port of Vancouver? Would Western does the relative priority of that real project, basically, is it still something you want to get done? Or does the priority change relative to other opportunities in Western's portfolio?

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

Yes, because so much time has transpired, like you just said, we have done all the engineering work. So we in the scope has remained very constant over time for everything, all of the -- what we call our major capital projects. So we feel really good about the definition of the project and the ability to go out and execute those projects now. And so, thank God, we finally got to a point where we can get into the execution phase, because we -- the ideas and the ability to go deliver those ideas is a critical part of how we're trying to create value. So they haven't changed that. We are now in our planning phase for the company as we kind of look out for the next 5 years, which gives us a good opportunity to look at the ideas and the opportunities that came from the acquisition, and put those into the whole mix of the company. And I think what's very important, and we want to be absolutely crystal clear and Steven reiterated earlier this morning, and I know we say it almost every time is that, we are going to take and use a portion of our free cash flow to reinvest in strategic, high-return capital projects that are not driven by a crack spread. We will find ways to go in and add value like we're doing with the L.A. project, like the isomerization project, Vancouver and on and on and on, that we need to be good stewards of the capital of the company and invest it very wisely. And so we're now in that process, and we're looking at now the entire portfolio of ideas and opportunities, and allocate the capital accordingly to get the highest return. And so we don't know how that will impact the new assets.

Operator

Your final question comes from Chi Chow with Tudor, Pickering, Holt.

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

Back on Mexico, Greg. Could you just talk at a high level what the challenges are of doing business there? And any additional measures you need to consider going into that market versus the U.S.? And then secondarily, how do you think Pemex will manage the progression of rollout, opportunities, so it's coming to other states?

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

Yes, I think what we've experienced so far is that for the people in Mexico, this is a tremendous change as they open up their markets and engage in a very competitive marketplace. So one of the challenges has been to work kind of effectively with the people in Pemex to be able to think through how you approach the opening and how you structure agreements that work for everyone involved, and address all of the different issues that you have in any business like that. So I -- it's probably that old saying, "The devil is in the detail." But that's probably the biggest challenge, Chi, is just being able to work through all of the little details from the trucking operations to get to the gas station to getting efficient supply into the market, because at the end of the day, we need to cost effectively supply the people in Mexico. And so it's a combination of lots of small things that you need to work through, and you need to just be very thorough in addressing each of the challenges, and some present maybe a little bit more risk than others, but you work from all in it, and it just takes some time to do that. We feel that the work that our people have done so far is excellent. We feel like the way that we are positioning our business, that we're creating an excellent platform to be able to grow, go in and get good supply into the part of the country that we have targeted to grow in, that we would be able to get our supply into the market, that we would be able to get the distribution, and then provide excellent service to those customers, which initially will be kind of the branded [jobber] concept, using the ARCO brand in the country. And look, like I said earlier, I think in response to Neil's question, it's going to take us some time to develop a strong business in Mexico.

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

Right. Initially, are you targeting all the incremental 30,000 to 40,000 barrels of this slide through that brand in ARCO network? Is that the plan?

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

So just to maybe clarify, the way that we've gained access into the distribution system gives us the potential to take in 30,000 to 40,000 barrels a day, and we'd love to be able to get that much volume into the marketplace. And so initially, we will go in with the -- from the branded standpoint, and then look at other opportunities, but we will take it in and deal with commercial accounts and other accounts in the country, and just grow the portfolio out over time.

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

Okay, great. And then maybe one question, Greg, on marketing. You've got now branded and unbranded broken out. It looks like the unbranded is not a huge contribution, but how do we think about the drivers of the margins that you are reporting branded versus unbranded? Looks like they're -- they don't track the same.

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

Yes, competition. It's just the market, the competition in the marketplace, and we have ways that we supply our customers and it's just driven by market forces on how that comes out and it will be variable over time. I mean, as you know, sometimes it's impacted by the change in crude prices as the market follows or lags the movement in crude prices and that, and so hopefully, this information will just give a better track record of how it looks out over time, but it is variable.

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

Okay. And where does the RIN value show up? Will you report now?

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

So our approach on RINs has always been that we look at the way the program works and that our marketing business, in some cases, generates RINs, and our refining business is the obligated party. And so the -- if the RIN is captured in marketing, it shows up in the marketing segment, and if it's a obligation, the obligation comes through refining.

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

Okay, so is it through marketing? Is it through the reported fuel margin?

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

Right. That's right. If you get it, right?

Operator

At this time, we are showing no further questions. Ladies and gentlemen, thank you for your participation in today's conference. This does conclude the program, and you may now disconnect. Everyone, have a great day.

Editor

FORWARD LOOKING STATEMENTS

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