3Q17 Earnings Conference Call Edited Transcript

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This transcript has been edited by Chevron Corporation. It is generally consistent with the original conference call transcript. For a replay of the earnings call for the third quarter of 2017, please listen to the webcast presentation posted on chevron.com under the headings "Investors," "Events & Presentations."

Transcript

Operator:
Good morning. My name is Jonathan, and I will be your conference facilitator today. Welcome to Chevron's Third Quarter 2017 Earnings Conference Call. (Operator Instructions) As a reminder, this conference call is being recorded.

I will now turn the conference call over to the Chairman and Chief Executive Officer of Chevron Corporation, Mr. John Watson. Please go ahead.

John Watson (Chairman and Chief Executive Officer, Chevron Corporation):
Thank you, Jonathan, and welcome to Chevron's Third Quarter Earnings Conference Call and Webcast. On the call with me today are Pat Yarrington, our Vice President and Chief Financial Officer; and Frank Mount, our General Manager of Investor Relations. We will refer to the slides that are available on Chevron's website.

Before we get started, please be reminded that this presentation contains estimates, projections and other forward-looking statements. We ask that you review the cautionary statement on Slide 2.

Turning to Slide 3. Let me start by revisiting the 3 messages we delivered in March at our Analyst Day. First, we are growing free cash flow. Third quarter cash flow after dividends excluding asset sales proceeds was approximately $500 million. As shown on the chart, including asset sales proceeds, we generated $2.8 billion.

Second, we're focused on improving project, book and cash returns on investment. Projects are coming online, reducing pre-productive capital, and revenue is being realized from growing volumes. Spend is shifting to shorter-cycle time, high-return investments in base business and shale and our cost structure is lower.

Finally, we're focused on unlocking value from our advantaged and balanced portfolio of opportunities highlighted by legacy positions in Australia, Kazakhstan and the Permian.

Let me now turn the call over to Pat, who will take you through the financials. I will follow her up with some operational updates and a few closing thoughts.

Pat Yarrington (Vice President and Chief Financial Officer, Chevron Corporation):
Thanks, John. Starting with Slide 4, an overview of our financial performance. Third quarter earnings were $2 billion or $1.03 per diluted share. Included in the quarter was a gain on the sale of our Canadian refining and fuels marketing business of $675 million and charges associated with a project write-off of $220 million.

Foreign exchange losses for the quarter were $112 million. A detailed reconciliation of special items and foreign exchange is included in the appendix to this presentation. Excluding these special items and foreign exchange impacts, earnings totaled $1.6 billion or $0.85 per share. Included in this total was a catch-up depreciation adjustment of about $220 million related to our Bangladesh upstream business, which we have decided to retain.

Cash from operations for the quarter was $5.4 billion, reflecting continued strong downstream performance and the impact of growing volumes and higher realizations in our upstream business. A working capital draw benefited the quarter but was mostly offset by an increase in notes receivable.

Our debt ratio at quarter end was just over 22%. Our net debt ratio was approximately 19%.
During the third quarter, we paid $2 billion in dividends. Earlier in the week, we declared $1.08 per share dividend payable in the fourth quarter. We currently yield 3.6%.

Turning to Slide 5. During the quarter, net cash generated after C&E and dividends was $2.8 billion, including $2.3 billion in proceeds from asset sales. Year-to-date, net cash generation after dividends stands at $3.8 billion.

Cash flow from operations was $5.4 billion during the third quarter. It was a strong quarter despite approximately $600 million in pension contributions and affiliate dividends being the lowest we've had this year. Year-to-date, cash from operations has totaled $14.3 billion. Lower affiliate dividends than earnings, working capital consumption of funds and deferred tax effects in the aggregate totaled nearly $3.3 billion through the first 9 months.

Cash capital expenditures were $3.2 billion for the quarter, approximately $800 million lower than the third quarter of 2016. Year-to-date, cash capital expenditures were $9.8 billion, over 30% lower than the same period a year ago.

Third quarter asset sale proceeds were approximately $2.3 billion, reflecting the sale of our Canadian refining and fuels marketing business, select Central Basin Platform assets in the Permian, international interests in the Natuna Sea in Indonesia and gas assets in Trinidad and Tobago. Year-to-date asset sale proceeds now total $4.9 billion. We are confident that we will exceed our objective of being cash balanced this year, including asset sales.

Turning to Slide 6 now. Slide 6 compares current quarter earnings with the same period last year. Third quarter 2017 earnings were approximately $700 million higher than third quarter 2016 results. Special items, primarily a $675 million gain on the sale of our Canadian refining and fuels marketing business, offset by a project write-off of $220 million and the absence of special items in the third quarter of 2016, increased earnings by $165 million. A swing in foreign exchange impacts reduced earnings between the periods by $184 million.

Upstream earnings excluding special items and foreign exchange increased by about $800 million between periods. Higher realizations and increased volumes were partially offset by higher DD&A, both from the increased production and, as previously mentioned, from the catch-up adjustment in Bangladesh.

Downstream results excluding special items and foreign exchange increased by $55 million. Higher global refining margins were partially offset by a swing in timing effects, resulting from rising prices.

Turn now to Slide 7. Slide 7 compares the change in Chevron's worldwide net oil equivalent production between the third quarter of 2017 and third quarter of 2016. Third quarter 2017 production was 2.72 million barrels per day, an increase of more than 200,000 barrels per day over the third quarter of 2016.

Major capital projects increased production by 263,000 barrels per day as we started and ramped up multiple projects such as Gorgon and Angola LNG. Shale and tight production increased 39,000 barrels per day, primarily due to growth in the Midland and Delaware basins in the Permian.

Lower planned turnaround effects, primarily at Tengiz, favorably impacted production between periods by 54,000 barrels per day. Base business growth of 44,000 barrels per day reflected additions from new wells, mostly in the U.S. Gulf of Mexico and Nigeria.

The impact of asset sales reduced production by 76,000 barrels per day, approximately 45,000 of which were due to 2017 asset sales that impacted third quarter production. Overall, production increases were partially offset by normal field declines and PSC effects.

Now I'll turn it back to John.

John Watson:
Okay. Thanks, Pat. Turning to Slide 8, our production is growing as major capital projects come online, the Permian ramps up and we manage declines in our base operations. At the beginning of the year, we said that production excluding the effects of 2017 asset sales would be up 4% to 9% from 2016. At 9 months, production before current year asset sales is up approximately 6%, in the middle of the range. We now expect the full year growth to be in the range of 6% to 8%.

The bar on the right shows year-to-date production including the impact of 15,000 barrels a day in 2017 asset sales. We completed our final shallow water Gulf of Mexico transaction. We sold certain Permian properties and divested international interests in Trinidad and the Natuna Sea in Indonesia. We now expect the impact of 2017 asset sales for the full year to be 30,000 barrels a day. As Pat noted, we've canceled the sale of our Bangladesh gas business.

Turning to Slide 9. Gorgon continues to ramp up. Total production was more than 400,000 barrels a day in the third quarter. We finished a successful maintenance pit stop on Train 1 in early October. The 3 trains are currently averaging well above nameplate capacity. As we fine tune the plants to enhance reliability and improve volumes, we'll likely have intermittent downtime on other occasions.

At Wheatstone, we announced first LNG production from Train 1 on October 9 and are currently ramping up at 65% of capacity. Loading arms are connected, and we're in the process of loading the first cargo. We expect production to ramp up to full rates over the quarter. We have scheduled downtime to remove temporary strainers in December.

Upstream well performance for both projects is at or above expectations. First LNG for Wheatstone Train 2 is scheduled for the second quarter next year.

Now let's turn to the Permian on Slide 10. Unconventional production in the Permian continues to exceed expectation. Volume was 187,000 barrels a day in the third quarter, up 30% from third quarter a year ago. Our new basis of design is proving quite effective, and we're standing up our 15th operated rig. Our proprietary database contains over 5 million well attributes encompassing most Permian wells. We continue to apply data analytics and petrophysical technology to that information to drive improvements in well targets and performance.

Volume growth is one outcome of our activity. Of course, the more important outcome is the return we generate on the money spent to achieve this volume growth.

Earlier this year, we indicated our IRRs on Permian investments were more than 30% at $50 a barrel WTI. I thought it would be helpful to share information from some recent appropriation requests approved under the new basis of design, and we show that on Slide 11. These are fully loaded cost economics.

On the left are the operating and financial parameters for 3 pads currently being developed with 10,000-foot laterals. Based on our type curves and costs, we expect to recover an average of about 1.9 million barrels per well with $14 per barrel capital, operating and overhead expenditures. At $50 a barrel WTI, $2.50 Henry Hub and $25 a barrel NGLs, revenue from oil, condensate and gas streams will weight average $33 per barrel.

Our realizations are advantaged by our legacy royalty position and add to strong returns. As you can see by the chart on the right, the typical profile of cumulative cash flow from production allows capital to be recovered very quickly. We

expect the average time from initial investment to pay back to be about 28 months and cumulative cash flow over the life of the pad to be nearly two times the capital costs. This is very good use of your money.

Capital and operating expenses continue to trend down. Capital expenditures averaged $4.5 billion per quarter this year, down by more than half from 3 years ago. Following the normal intra-year pattern, fourth quarter spend will be higher, but we expect full year capital expenditures will be less than $19 billion.

We're also controlling operating and administrative expenses well. Average quarterly costs are down again this year, about $450 million per quarter lower than last year, despite higher upstream production, and 22% lower than 2014. We expect unit costs in the upstream to continue the downward trend.

Turning to Slide 13. Last year, I indicated we plan to sell $5 billion to $10 billion worth of assets in 2016 and '17 combined. Through 7 quarters, we've sold $7.7 billion, squarely in the middle of the range. In the third quarter, we closed the sale of our Canadian refining and fuels marketing business and the upstream assets I noted earlier. We expect no significant asset sales in the fourth quarter.

In South Africa, our minority shareholders exercised their right of first refusal and plan to purchase our refining and marketing assets there. We now expect this sale to close in 2018. Our criteria for asset sales hasn't changed and is listed on the chart.

Before taking your questions, I'll offer a few closing thoughts. As you know, I've announced my retirement effective February 1, so this will be my last earnings call. The financial community judges CEOs by TSR, and I'm gratified that we outperformed our peers during my tenure. That's an outcome my two predecessors established as a precedent, and we certainly owe much of our success in this long cycle time business to those that came before us.

During my time, we've seen tremendous volatility in price and cost conditions. On my first day in the job, back in 2010, oil was $80 a barrel, and Henry Hub was over $6 per MCF. Today, of course, prices are much lower, and that's impacted industry results and produced TSRs that have lagged the S&P 500 index. But the company has weathered the downturn, adjusted rapidly to new conditions and is well positioned for the future.

Including our fourth quarter declared dividend of $1.08, we've now increased the annual per share cash payout 30 years in a row, a record that is very important to us. We've also repurchased shares when it was prudent and have been conscious not to dilute the share count.

As you've seen in the results, we are at a cash flow inflection point with spending coming down and revenue from growing production going up. With the fourth quarter at current prices, we should be close to cash balanced without asset sales proceeds this year.

We have an upstream business that I believe can sustain itself at current prices, thanks to an enviable unconventional position highlighted, but not limited to, the Permian. I expect Australia will deliver earnings and cash flow for decades, and we've had a successful record developing a huge resource base in Kazakhstan. We have a tightly configured high-return downstream and chemical business that complements the upstream.

Most importantly, we've got a wonderful management team, organization and culture. You know Mike Wirth and his team well. They're typical of the talented and effective people that make up our 50,000 employees. Mike has a track record of success, and I know he'll do an outstanding job for you.

And with that, I'll take your questions. Jonathan, please open the lines for those questions.

Operator:
(Operator Instructions) Our first question comes from the line of Jason Gammel from Jefferies**.**

Jason Gammel (Jefferies):
First of all, John, I'd like to congratulate you on your highly successful tenure as CEO. You left things in great shape for Mike. And as a former Chevron guy, I've got a strong appreciation for the mark you've left on the company. So best wishes in all your future endeavors.

John Watson:
Thank you much, Jason.

Jason Gammel:
First question, John. Pretty significant major milestones you've achieved over the quarter with first LNG start-up at Wheatstone. Gorgon at full economic capacity. Now that you're transitioning from construction to operation, can you talk a little bit about some of the lessons that you've learned since you embarked on this big expansion in Australia, given that it spanned most of your tenure?

John Watson:
Sure. Jason, there are a lot of lessons we've learned. We went to FID back in 2009 on this project. A lot of the engineering work was done 10 years ago. A lot of the project planning work was done 10 years ago. And I think it's fair to say, we and the industry have learned a number of things during that time. I think the real lessons are around the assurance work we need to do and the preparatory work. We had a lot of reviews of Gorgon when we started. It was labeled by independent reviewers as the best prepared megaproject out there. And it's pretty clear that we needed to do more engineering in advance, and we needed to have better assurance work on some of the project planning and other aspects of the project. It's a complex project on Barrow Island. And if you miss a few things, you're going to incur some additional costs. We've learned from what we've done and what others have done. And we've tried to make some changes going forward on projects like FGP and elsewhere. I think, in a broad sense, we have to verify every single aspect of these projects in advance because we're on the hook for them regardless of the kind of contract that we sign. If a vendor or contractor doesn't perform or there's some element that we've not thoroughly vetted, during construction, we have to verify these [aspects]. We have to be sure that what we ordered gets delivered. We have to be sure that the designs are robust. We have to be sure of everything. And I think we had a different mindset going back a decade ago.

Jason Gammel:
That's great. And it's actually a good segue to my follow-up question. Thanks for the financial data on the Permian. With the basin moving into more of a manufacturing mode, can you talk a little bit about the advantages that scale and a strong balance sheet give you relative to smaller competitors?

John Watson:
Sure. When you look at the Permian and you look at Chevron, we have a portfolio advantage. We're generating cash flow from each individual investment that we make in the Permian, and that's a team effort, really. We have a strong procurement organization. We have a technical organization that supports our people in the Permian, and we have learnings that we're generating. We've talked a lot about data science, but there's more to it that's enabling us to learn from others so that we can spend our money very efficiently. We showed some charts last quarter that showed how we process the information from others, and we think we came up the learning curve pretty fast -- while drilling fewer

wells. And it's that kind of capability that I think is advantageous to us. Also, we have a portfolio where different assets have different roles. For example, right now, we can choose to pace how much we spend in the Permian. I showed you a chart that showed the kinds of returns that we have there, so we can scale that [investment]. We're continuing on our ramp up to 20 rigs. But we have the ability to ramp that up and really manage the cash flow. Overall, my view is the work we do, whether it's procurement, our advantaged royalty position, the integration that we have with our supply and trading organization, the technology, all those things are something that a big company can bring. And I think we're showing that in the results that we've been metering out to you guys every quarter.

Operator:
Our next question comes from the line of Paul Sankey from Wolfe Research.

Paul Sankey (Wolfe Research):
John, we first met a long time ago when you were the CFO, and I just want to thank you for the time and the patience you showed in dealing with guys like me and congratulate you on your retirement. We really can't argue with shareholder return as a measure, so enjoy. You've got me slightly fantasizing about retiring myself, but unfortunately, it's a long way off. With all that said, John, this result was pretty weak, if we look at cash flow, if we look at EPS, if we look at volumes. If we could just focus perhaps -- and by the way, there was a tremendous positive element here, which was the Permian slides. But if we could just focus on the cash flow, is there anything that you would highlight that made it look as weak as it did? Because I think we were a bit negatively surprised, quite frankly.

John Watson:
Yes, I saw how the stock opened. And I must say I was surprised because underneath [the headline results], I think we're doing pretty well. And so it won't surprise you, Paul, if we have a little bit of a disagreement on this, but in fairness, not all of it was apparent to you in the numbers. Let me talk through a couple of things, and I'll also let Pat make a comment. Earnings were $0.85 a share. We didn't call the Bangladesh catch-up depreciation adjustment a special item. Basically, what happens here is when you declare an asset is going to be sold, you suspend depreciation. When you decide not to sell it, you have to reinstate [depreciation]. So that was $220 million. We terminated a rig contract, which was $150 million before tax. [Each of those impacts] appeared in the numbers. We've also got some things going on in working capital that don't impact earnings per se, and let me have Pat walk you through a couple of those.

Pat Yarrington:
Two things on the cash flow side I would mention. One is the pension contribution. I called out a number of $600 million in total but $500 million of that was discretionary, and it's the first [discretionary] one that we've made all year. The second thing I would mention is we have a circumstance where, as you might expect over the last 3 years, there's been some difficulty in some of our partners actually paying us what they owe us. During the quarter, we were successful in negotiating more security around that ultimate payment. But [the resultant accounting] meant having a swap between what was a current receivable into a notes receivable. You ended up having a positive working capital effect in the quarter of about $600 million as we recognized this reclassification from accounts receivable to a notes receivable. When you look at our 10-Q statements and you look at what's happened in notes receivable, you will see there was no cash flow impact during the quarter for that. It did impact working capital, however.

John S. Watson:
What [Pat] is saying is the working capital adjustment is a touch misleading. Really, the news was good because we were able to provide better security around an arrear from one of our national oil company partners.

Pat Yarrington:

If you look through that, you're talking about our cash from operations on a headline basis and adding back the $500 million discretionary pension contribution. That gets you close to a $6 billion figure.

Paul Sankey:
Great. And, John, in all sincerity, thanks and congratulations.

John Watson:
Paul, thank you very much. I appreciate it.

Operator:
Our next question comes from the line of Neil Mehta from Goldman Sachs.

Neil Mehta (Goldman Sachs):
John, congratulations. John, first, a big picture question. The energy sector broadly hasn't created a lot of value over the last 10 years. Now a lot of that has to do with commodity price, but a lot of that has to do with capital allocation. Your stock has been one of the better performers. So short of handing off of the baton question, what's your message to the CEOs of the energy industry, whether it's the next generation of major CEOs, many of which have come from downstream, or the shale E&Ps?

John Watson:
If you look at our TSR since I started, it was just under 10%. But that's lagged the S&P, which, of course, gets heavily weighted by the FANG Stocks. But there's no getting away from the fact that we missed on the commodity side, which was largely a miss on technology. If you look at the miracle of hydraulic fracturing that has taken place since 2010, that's put supply on the market that we didn't anticipate. And so I think the message really is that we're a pretty resilient bunch in this business. And when prices go up, technology keeps moving, and we're able to respond to that very well as an industry. So never underestimate that ingenuity, if you will, because we're very, very good at what we do. Our industry doesn't get a lot of attention as a technology industry. But clearly, we have been, and that results in a transition. We are in a commodity price business. We really have to focus on the lowest cost projects and opportunities that we have regardless of the ups and downs that we'll see on a transitory basis in the commodity market. I suspect, Neil, that if we had commodity prices that were in the range that most of us anticipated, we would all have performed a lot better. And the message is be a little bit wiser about the quantity of projects that you take on, be very wary of the capabilities in the supply chain during those busy times that I commented on earlier and pursue your best opportunities. And that's what we're doing right now. You know well, we talk a lot about the Permian, but Vaca Muerta, as you've seen a little bit in the press, is performing very well. The Duvernay for us is good. The Marcellus. We've got four big shale opportunities that are very low cost. We've got continuing base business opportunities. And we're trying to drive down the costs in some of the longer-cycle time projects. The emphasis will be on getting a lot out of the assets that we have, particularly during this period where commodity prices are maybe lower than many have anticipated.

Neil Mehta:
Appreciate that, John. And then a follow-up, just around 2018 CapEx, recognizing that you're going to give us more color here in a couple of weeks with the December capital spending release but just how you're thinking about the drivers going into 2018 relative to the $17 billion to $22 billion band that's out there.

John Watson:
We indicated that if prices stayed in the near $50 range, then we would be towards the bottom of that $17 billion to $22 billion range, and I see no reason to modify that guidance. That will certainly be the case. We will get a plan approved in

early December I expect, and we will put out a C&E release after that. A couple of things I'll highlight for next year. 2018 and 2019 will be the peak spending time for the Future Growth Project in Kazakhstan. And of course, we'll continue to fund the Permian. But nothing has changed that will drive us away from being towards the bottom of that range.

Neil Mehta:
Thanks, John. Good luck with your handicap.

John Watson:
Thanks. Appreciate it.

Operator:
Our next question comes from the line of Phil Gresh from JP Morgan.

Phil Gresh (JP Morgan):
I echo everybody's sentiments. Congratulations, John. First question is just as I look at the production trends over the past couple of quarters, if you look at that base plus shale piece, it's been pretty flattish. And I think at the Analyst Day, you actually expected it to be more like minus 2% this year, and it will take a couple of years for that to get to kind of a 0 to plus 1% trend line. So maybe if you could just elaborate on why you've been able to outperform that base-plus-shale expectation? And how do you roll that forward and think about the outlook for the next few years?

John Watson:
Well, I think the outlook is nothing but good. If I think about the base business, our people are very focused on getting the most out of the assets that we have. So certainly, that has been a positive. Our in-fill drilling program, development well drilling off of our hosts in deepwater, et cetera, have been very successful for us, so that is certainly a positive. And then you see the Permian and other shale results have been good. I made a comment in my closing remarks that I think we're sustainable for a good period of time at lower prices. And that was sort of a code for what you are describing. I think we'll be in a position to grow production for a period of years just from the shale, frankly, and the projects that are continuing to come on line and ramp up. So I think that's very positive. We'll go through our normal cycle with you, where, on the fourth quarter earnings call, we'll give you an estimate for production for next year. But I think looking forward with the continuing ramp-up of major capital projects and the success we're seeing in the Permian and elsewhere, it will be a good news story.

Phil Gresh:
Okay. Second question just on the dividend. Obviously, acknowledging the long-term track record, I think some investors maybe were a little bit surprised not to see a modest bump with the dividend in the fourth quarter as we lap last year's fourth quarter tweak-up. So maybe just share your thoughts on that in the context of the broader picture?

John Watson:
Sure. I said in my closing remarks, we like the dividend. The board likes it and every member of management that I know likes increasing the dividend. And you've heard me over time, we've said we'll increase it as the pattern of earnings and cash flow permits. I've also said that we wanted to be sure that any increase in the dividend is ultimately sustainable. I said I wouldn't knowingly increase the dividend if I didn't think we could sustain it in perpetuity. So we put a high bar on increases. And I'll say, the story inside the company is very good. We chose not to increase the dividend this quarter, in large part, based on the time of year that it is and the potential risks that we see in the marketplace in the fourth quarter and early part of next year. There's uncertainty around OPEC, and there's just always uncertainty in the marketplace. Having said that, if you look at where prices are today, it may have been a conservative call, to be honest.

But the great thing about the dividend is we get an opportunity to reconsider it every 90 days. And so our board will take a close look at it every quarter, and I'll remind everyone that we've increased the annual per share cash payout 30 years in a row. And I expect that will be a priority going forward.

Operator:
Our next question comes from the line of Doug Leggate from Bank of America Merrill Lynch.

Doug Leggate (Bank of America Merrill Lynch):
John, I'm going to add my congratulations also. I'm in the same generation as the Sankey CFO time line, so thanks for putting up with us for the last 15 years. We've really appreciated it. It looks like you're going out on a high with oil above 60. Relatively speaking, anyway. All right. So two questions, both high level, John. I'm going to apologize for not asking any specifics about the quarter, but your legacy has been established on maybe -- you can manage through the establishment of a very large legacy asset base that's obviously driving this inflection of cash flow. Mike Wirth's track record has been something of cost-cutting and asset sales, generally in the downstream. I'm just wondering, given the succession planning and the continuity of strategy, with the flexibility in the Permian, how do you see those two things coming together as Mike steps in? And really what I'm getting at is do you think there's an opportunity for a more aggressive resizing of Chevron's portfolio, given that those major changes have taken place? And I've got a follow-up, please.

John Watson:
Yes, Doug. That is a broad question. And I think it's certainly true that during my tenure, we've had some significant capital projects, and we've seen a wild ride in the commodity cycle markets. I do think those investments give Chevron a lot to work on. I've described it internally as we have a lot to chew on over the next few years. So what do I mean by that? What it means is we have to ramp up Gorgon and Wheatstone, fine tune them and get the most out of those young assets and then debottleneck them over time. I would describe that as base business-type activity. We have a Permian business that has a lot of momentum behind it. And we have other fresh assets that have been or will be coming online that will give us a lot to work on for incremental returns over time. And those incremental efforts and outlays of capital will, in general, be smaller. And they'll likely have higher returns because they're building off existing infrastructure. I think it's a wonderful opportunity. And certainly, Mike is very familiar with that because one of the things the downstream business has done well -- all downstreamers have done it, Mike did an exceptional job –- is being penny pinchers in the sense that they've learned how to eke more out of the refineries, and that's exactly what we want to do with our assets. But I think it undersells Mike to describe him as just a cost cutter because, actually, there have been opportunities to grow in the downstream business that we've taken advantage of over time. Mike has been a part of my leadership team for a long time. He's been in other leadership positions also so there will be elements of growth likely over his period of time. Whether it was Mike or somebody else [as my replacement], I don't think we would have a big period of additions to the capital base [as compared to the time] that I went through. But I would encourage you to think about Mike as being great at grinding returns out of the business but also very balanced in his capabilities. You've got a chance to talk to him, you know he's a very broad guy.

Doug Leggate:
Well, we're looking forward to it, but we'll miss you just the same, John. So my follow-up is I'm going to have a little fun with you now because I think as you walk away, I think you've been quoted multiple times on the prospect of peak oil demand. I think wishful thinking is probably putting it kindly as to what your response was. I wonder, if I could just ask you as you walk away to offer your thoughts on the commodity outlook and this concept of peak oil demand that seems to be current fashion.

John Watson:
Sure. I just try to speak factually about what I see out there, and I am an unabashed advocate for our industry. Our industry is responsible for the greatest advancements in living standard in recorded history. And literally, light, heat, mobility, mechanized agriculture, everything that we have, every shred of our standard of living has been provided by our industry if you look back 100 years. So that's the context in the statements that I make. And as to the comments on demand, I'm just repeating what the International Energy Administration and others state. In fact, if you look at our demand forecast going forward, they're very similar to those of our competitors. When people talk about peak oil, they're simply not looking at facts and data for the foreseeable future. Now technology advances, and that's a good thing. And there will be other forms of energy that will come into the energy mix. But I think good debate on energy policy starts with a good grounding of the facts. And peak oil [demand] will happen at some point but for the foreseeable future as the developing world puts in place economic systems to generate the kind of standard of living that we have and the infrastructure that's associated with it, it's pretty clear that oil demand is going to grow. In fact, demand estimates for next year are up again. We're getting close to 100 million barrels a day. Natural gas demand is growing, and our products are needed. And we have to be able to provide them in an environmentally safe way and an environmentally responsible way. We really ought to have deeper debate on these subjects based on a well-grounded set of facts. And so that's where I come from when I make the kind of comments that I do.

Operator:
Our next question comes from the line of Paul Cheng from Barclays Capital.

Paul Cheng (Barclays):
John, I want to add my congratulations. I think that makes me feel really old because I think I met you more than 20 years ago. So that has been a wild ride. So I really appreciate that.

John Watson:
You're seasoned, Paul. You're not old.

Paul Cheng:
That is a very nice term. But anyway, I really want to say congratulations, and thank you that putting up with all the nasty sell-side analysts. I really appreciate it. So with that, maybe -- I have two questions. First, if we look at the industry, we've been nearly constantly going through the boom and bust, partly it's probably related to the normal commodity cycle, which naturally that is going to have volatility like that. But I'm wondering that you said also partly it's because the industry how it is being managed or that is being compensated. So I mean, as you're departing and go to retirement, John, when you look at the industry, do you think the way that how it's being managed or how it's being compensated needs to be changed? Or that cycle is just naturally going to be here and not much can be done?

John Watson:
Well, I think that's, in many ways, a company-specific question because if you look at our comp system, we've had a pretty balanced compensation system for a long time. And for those that aren't aware, there are four big components to it. One is a salary that's based on competitive data. Two is a current year cash bonus, which is based on a scorecard. And I would invite anyone to take a look at Chevron's scorecard, and it has a variety of things, including returns, health, environment and safety, project progress and things of that sort. Now we've enhanced our disclosure on that in recent years, but I think it's up to standard. So that's for the current year cash bonus. And then we have two other long-term components that are 100% aligned with shareholder return. The first is a relative TSR performance unit. And just last year, we added the S&P 500 as one of our competitors. That is married up with what, for the most part, in the past has been options that have been granted to align with absolute shareholder performance over time. And the thinking

behind those components for us has been that you will have these ups and downs. And so if in an absolute sense we don't perform well, options won't return much. If in a relative way, we outperform all of our competitors, we'll get that [TSR performance unit] component. But if it's a downtime for the industry, you won't realize value from the options. And so it's really quite balanced, and it's very returns-focused, whether it's TSR-focused or returns-focused in the scorecard for the current year along with other current year performance information. The outcomes that we've achieved have largely been a function of the commodity price environment. We made $26 billion when oil was high, and we made nothing when oil was $42 per barrel. And so it's been a volatile ride. But if you look at those components together over time, I think ours has been a good system. I think there's a wide range out there in the industry. I read the same articles you do, and I've read some of the proxies and some of the information that other companies put out there, and I think you're seeing a response by shareholders and by management.

Paul Cheng:
The second one, I don't know whether you want to comment, but since that you're retiring, you may. What will be your advice to the high officials in a number of the oil-producing countries, the way they manage the industry and that -- or how the oil revenues is being -- I mean, not to mention how oil revenue is being managed inside but that how that their relationship with the oil industry and how they can do better in terms of attracting the investment dollar.

John Watson:
Well, Paul, we talk a lot about the strain on the private companies like Chevron during this period of lower prices and the adjustments we've had to make. And I said on previous calls, host governments are going through the exact same type of change. The difference is we have dividends, while they have social spending commitments. And so they're wrestling with lower revenues. They've made commitments to their people, and they've got trade-offs to make. I think they're in the process of making those trade-offs. The advice would only be that it's a competitive world out there. When I talk to heads of state or governments, we are economic agents, and we respond to the incentives that are out there. Putting in place a system that's going to draw capital and be viewed as stable over time is very important. And we're seeing some countries that are responding to that. We're seeing others that aren't. When they don't respond, when it's not economic, private companies walk with their feet. These transitions can take time because of trade-offs that host governments have between keeping the cash and not adjusting their fiscal terms, and adjusting the terms to draw capital so that companies can make the kind of long-term investments that will deliver benefits over a longer period of time for [the host countries]. Those are the things that I think have to be considered, and most governments eventually get there.

Paul Cheng:
Well, congratulations. And hope you have a lot of fun in your retirement.

John Watson:
Thank you. Appreciate it, Paul.

Operator:
Our next question comes from the line of Doug Terreson from Evercore ISI.

Doug Terreson (Evercore ISI):
Well, first, John, congratulations on your stock beating every peer during your tenure and over five and 10 years, but I don't think you need any help with your handicap. I think that's pretty good. So my question is Chevron had this pledge to focus on returns on capital employed and free cash flow, which you guys highlighted on Page 3. And it's had a long history of positive shareholder outcomes. Simultaneously though, a lot of times investment discipline will falter as

surplus capital materializes, and Chevron looks likely to have a lot of surplus capital during the next couple of years. So my question is how significant do you consider the challenge to manage this transition to be? And besides some of the commentary that you and Pat made on spending and distributions, are there any other things that we should focus on, which underscore Chevron's commitment to value creation going forward?

John Watson:
I don't want to advertise my successor is going to have an easy time because there will be challenges that the industry will face going forward. But I think we're in a good place right now because we have projects coming online and more that are coming. They are going to deliver cash flow. I actually think that there's a very high chance that we'll be very disciplined for a whole variety of reasons. One, the opportunity set that we have tends to be shorter-cycle shale opportunities as we've highlighted. Second, if you compare the current period with the period, say, 10 years ago, we knew we had a number of major capital project opportunities coming up and others that were in the hopper. I won't relive all the history of timing of funding of Gorgon and Wheatstone, Jack/St. Malo and some of the other large projects that we have had, but we clearly don't have that array of gigantic projects coming up. We are funding in a countercyclical way the FGP project in a place we've been very successful in Kazakhstan, but the number of projects that we have going forward [is reasonably well set] over the next few years. In other words, there's not some $20 billion or $30 billion project expenditure that's progressed to the point that would likely get funded during this period. I think the discipline will be pretty clear. And in fact, Mike will have the opportunity to give you an update on the capital spending range at our normal meeting in March.

Doug Terreson:
Well, listen, Chevron is set up well. Congratulations again, John.

Operator:
Our next question comes from the line of Evan Calio from Morgan Stanley.

Evan Calio (Morgan Stanley):
I want to congratulate both Mike, I'm sure he's listening, and echo the congratulations, John, on your tenure. It has been a pleasure working with you, and I wish you the best.

John Watson:
Thank you, Evan.

Evan Calio:
My first question, bigger picture. John, you've been a strategic thinker. You've been involved in acquisitions of Unocal as well as the Chesapeake acreage and others. I think, last month, Chevron made a compelling case that the majors can really win in unconventionals. My question is what do you think the U.S. shale industry structure looks like in five years? I know it's less necessary for Chevron, but do you think that, that industry will significantly consolidate over time? Or any thoughts there would be interesting.

John Watson:
I do expect there to be some consolidation. I think a lot of the land work that's taking place, certainly for us, but for many others as well, is called coring up, and it's really making sure that you've got contiguous acreage positions so that you can drill the kinds of laterals you want to drill and put in place the infrastructure that you want so that you can deliver good returns very efficiently. I do think that there will be that focus. And we're engaged in dozens of different transactions that are underway to do just that, which we've highlighted. Whether there will be broader consolidation, I

think, depends a lot on valuations. Now valuations have come back into line recently so it may create some of that opportunity. From our way of thinking when it comes to M&A, we like the positions we have. I've made it pretty clear in the past that we don't have to do any particular acquisition at this time. But at the same time, I've also said that we're in a resource business. And so whether it's adding volume through exploration, discovered resource or M&A, we'll likely participate in all of those things. If there were a bolt-on opportunity, we'd consider it. But it really would be driven by the question of how does it fit? The question I always ask our people when we do M&A is what do we know that the market doesn't? And how can we add value that wasn't contemplated here? Any time we would engage in a transaction, I would encourage you to ask us that question because that's the question that we ask ourselves.

Evan Calio:
Great, John. There's always room for a Watson SPAC out there if you choose to follow your peers and not work on your handicap. My second question is on the Permian, more detailed, new Slide 11. Can you give any color on what percentage of your '17 or '18 programs will be this new well design? And any indication on how that affects your guidance, which I presume is predicated on the prior completion design?

John Watson:
Virtually all of it is under this new design. We've been migrating to that design. I hope this chart was helpful to you because it's three pads that we've had. We monitor the type curves and the performance against them. These are 10,000-foot laterals. There are some that won't necessarily be 10,000-foot laterals, but that's certainly what we're striving for in most areas.

Operator:
Our next question comes from the line of Roger Read from Wells Fargo Securities.

Roger Read (Wells Fargo):
Congratulations, John. It's certainly been a solid run.

John Watson:
Thanks, Roger.

Roger Read:
I just wanted to follow-up. Pat, this actually may be a question more for you. In the presentation, the change in depreciation, which I'm sure is driven mostly by Gorgon and the coming Wheatstone, is that accurate? And is that the right way to think about the -- obviously, a little less large but the impacts of Wheatstone coming forward as well.

Pat Yarrington:
Yes. A lot of it would be volumetrically related. I do call you back to the Bangladesh depreciation catch-up component that was in there this quarter for $220 million. But the fundamental underlying components are going to be related to volumetric increases that we've had quarter-to-quarter. It also depends on which periods you're looking at. Third [quarter 2016] to third [quarter 2017], of course, is up significantly. Second [quarter 2017] to third [quarter 2017] is not exactly the same scenario, but that's where the Bangladesh catch-up shows itself.

Roger Read: Okay. Great. And then as a follow-up to that as we think about the slide on the Permian and all and, obviously, very attractive F&D and ultimate depreciation costs there, does that trend down overall for the company? Or is the Permian not likely to be large enough to -- for that to be the case over the next couple of years?

John Watson:
Overall, there's a balance between depreciation that's coming on from Gorgon and Wheatstone, which we've said is largely between $20 and $25 a barrel. And then the ramping down of depreciation that's taking place in the Permian and unconventional business. We flagged that last quarter as going down from $19 a barrel down to $13 a barrel and, frankly, even lower than that as we move forward with this new basis of design and more volumes at lower cost coming into the mix. Maybe I'll defer on what the exact number will be each year, and we can come back to you with a little bit of guidance in that way. We haven't finalized our plan, but you're correct that it's a balance between those two.

Operator:
Our next question comes the line of Guy Baber from Simmons.

Guy Baber (Simmons):
John, just echoing everyone else's comments. Congrats on a great run here.

John Watson:
Thank you much.

Guy Baber:
I wanted to circle back to the CapEx kind of framework, but as we think about the level of spending right now going to your base upstream assets, so setting aside your shale and tight program and the spending associated with major projects, how comfortable are you with the current spending level for those assets just in terms of sufficiency to sustain the base? And really, just trying to understand if you see a need to step up that base spending level or not given the efficiencies, which you seem to continue to realize, and maybe how much flexibility there might be with oil prices where they are right now.

John Watson:
Well, if you look at the base level spend, excluding the major capital projects that are part of that base, it has been about $6 billion a year. So we've been at the bottom of that range. In our guidance going forward, we will have projects that will be associated with some of these new assets. So there will be base level of spend. Some of these base projects are not trivial in the sense that some of the deepwater well programs that are off existing hosts and things like that are there. But I think what you'll see is a higher percentage of our spend will be in the category of base and shale going forward. In terms of the precise number, we'll give you the usual split that we do in March. But the general trend is in the direction that you described. And certainly, it's driven by economics.

Guy Allen Baber:
Okay. That's great. And at the risk of getting into the weeds here, on cash flow, as we dial in our 2018 cash flow and free cash flow expectations, just in light of some of the year-to-date headwinds, can you speak at all to some of those less obvious drivers of free cash flow next year that might be hard for us to see but important to consider? And just thinking if there's any high-level observations perhaps around the evolution of deferred tax or potential tax refunds, given where oil prices are right now, necessary contributions to TCO that might or may not be needed and then even maybe even a step down in pension payments next year, given the discretionary contribution. But just wondering if you could put any color there.

John Watson:
Let me make an overall comment about cash flow. There often are some things that are difficult to see. We've given you guidance on how sensitive we are to oil prices, for example. We said it's $350 million [change in cash flow] per dollar

[change in Brent]. But the devil's in the detail on that and particularly depending upon the range of prices that it's covering. For example, right now if we happen to have negative taxable income, the leverage is higher in a particular jurisdiction. I think that's part of why we've said that we are exposed to the upside to commodity prices. I do urge some caution in the sense that we have a major affiliate, for example, in Kazakhstan that is incurring spending that runs through the affiliate and that can impact dividend from or capital contributions to that company. It's not the normal consolidated operations. So those kinds of things can impact us, and Pat can make a couple of other comments.

Pat Yarrington:
Yes, I'd just say if you're thinking about the future, pension contributions are something we look at every year. In terms of the U.S. pension plan, we're not in a statutory requirement to make a funding. But in the past, you will see over time that we have [spent] up to $500 million and in healthier days spent $1 billion per year. That is a consideration that we will look at every year, but it's completely discretionary. John mentioned the affiliate component. The other one that I would highlight is on a deferred tax basis, we have been in a position where our deferred tax had been a headwind for us this year and in the last couple of years. As I look forward, obviously, prices will be a huge impact as to when those, in fact, reverse. But if you look at reasonable price ranges around what we've had here in the 50s, I think you should anticipate it will take some time for that cash benefit to come back into our actual cash coffers. It will be a bleed out over time where the net operating losses that are creating these tax cash carryforwards, in fact, get monetized. But it's a pretty slow bleed off if you're looking at prices around [where they are] today.

Operator:
Our next question comes from the line of Ryan Todd from Deutsche Bank.

Ryan Todd (Deutsche Bank):
Thanks. I'll echo all those before me and pass on my congratulations, John. It's been great, and good luck with what's next. Maybe a question, you've touched a little bit on this on various questions earlier but a number of your integrated peers, including your U.S. peer, who also reported this morning have been relatively active over the last couple of years in global asset markets acquiring resources in global LNG, Brazil or various locations. You guys have remained relatively on the sidelines through most of this. Can you talk about how you're thinking about managing investment priorities not just for the next few years but also how you view in terms of how your portfolio is positioned post-2020? And whether your decision to kind of stay on the sidelines through much of this over the last couple of years represents -- is it just portfolio position relative to what you think you have? Or is it a slight shift in investment philosophy longer term?

John Watson:
I think it's been a couple of things, Ryan. One is, as you say, the portfolio. We've got a very good portfolio. We've got 1.5 million acres in the Permian. We've got a lot to do and to digest there and in the other unconventional positions. We have a good resource base position, and we have growth ahead over the next few years as we continue to bring on these projects and develop them and grow the shale. So one, we do have a good position. As you point out, you do have to add resource over time, and that's why I made the comment that I did earlier. But I'll tell you we look at what's going to compete for capital in the portfolio against the opportunities that we have. And for much of this time period over the last few years, there's been an imbalance between the expectations of buyers and sellers. And so you can't always reach commercial agreement or you may just see things that are out of the money. And so we've been very cognizant of that. Now I highlighted earlier, and I said in previous calls, that we have a watch and brief on a lot of different opportunities, whether they're asset level transactions or companies. We do watch that very carefully and over time, we do need to add assets to our portfolio. But we've made some choices based on costs. We exited the Australian Bight, which was a difficult decision. We've got a good relationship with the government, but that [opportunity] wasn't going to compete

for capital going forward. So we're really trying to be true to what we told you, where we're being returns-focused and we're spending our money on what we think will be most economic.

Ryan Todd:
That's helpful. And maybe a follow-up on the chemical side of the business, I mean you continue to see potential expansions talked about in the chemicals industry, particularly in the U.S. Gulf Coast. I know you have a cracker starting up here early next year. But can you talk about maybe what you view as future growth opportunities on that side of the business within CPChem? How aggressive you'd like to be? And whether your Permian position, whether you think it allows for a certain amount of integration across the value chain there?

John Watson:
As all of you know, we've got a good relationship with Phillips and Chevron Phillips Chemical Company is the primary vehicle through which we invest in petrochemicals. We do have the derivatives plant onstream and the ethylene plants coming on early next year. We have contemplated other expansions with them. I think it's fair to say that the economics of those have the potential to be good and certainly, the continued growth of NGLs and the growth in the Permian is going to contribute to an advantaged feedstock position for a long time to come. But with the overall drop in prices that we've seen and the impact on naphtha, [the opportunity for returns is] tighter than it was previously. Our focus right now is getting the project we've got online, getting through that storm damage and bringing the second phase of the project up, and then we'll consider the other opportunities.

Operator:
Our last question comes from the line of Anish Kapadia from TPH.

Anish Kapadia (TPH):
My first question was on exploration. You pulled out of some frontier areas you mentioned the buyer I think the Senegal and Mauritania area as well. I just wondered how do you think about the role of exploration and resource replenishment going forward? And how do you see exploration stacking up relative to known resource in the current market?

John Watson:
I think you'll see us putting more money into existing basins where we have a lot of expertise. So, for example, there will be a focus for us on the Gulf of Mexico pending conditions, Nigeria's prospective [opportunities] and some of our other existing basins. Remote areas, whether it's Arctic or Australian Bight or others are just not likely to compete for capital. We do have a little bit of exploration work that we'll do to continue our appraisal and assessment of some of our unconventional positions that are out there. But if you look at where resource adds are coming from and where reserve adds are coming from, I think you're going to continue to see strong contributions from our four unconventional businesses going forward.

Anish Kapadia:
And then I had one follow-up. So it feels like we're bottoming out in terms of costs in the international markets as (inaudible) as well. So from that regard, I was wondering if you could give some kind of update on the potential FIDs that you've thought to take. I'm thinking about Rosebank, Tigris and Anchor in the Gulf of Mexico and some projects in Indonesia. Are any of these likely to be FID'd in 2018 if you can get the costs where you want them? And do you have the capital available to do it?

John Watson:

We're working very hard. For example, Anchor and Tigris in the Gulf of Mexico, those are in the concept development stage. We're not in FEED yet with those projects and a lot of the work that we're doing, for example, is to qualify equipment for the pressure regimes that we'll see. So there's industry work to achieve some of the milestones in that area. At the same time, we have joint teams that are working those two developments to see if we can design once and have enough commonality in design for not just those two projects. There are others in the industry working with vendors to try to do what we've talked about for a long time, which is to better standardize the development schemes to bring the cost down. That work continues on those projects. They're [Anchor and Tigris] not in FEED yet so you wouldn't expect to see FID. Rosebank has been in FEED and [the team] has been working very hard and diligently on both the concept and the cost, and they continue to make good progress. But I think it's fair to say that in a $50 world, we've got strong opportunities in the unconventional space and elsewhere. We're continuing to work that project. It's a good opportunity for us, but there's more work yet to do.

That concludes my prepared remarks for today. I certainly appreciate the very kind words that all of you stated. I've enjoyed my coming up on eight years in the role. I appreciate the dialogue that I've had with both the sell side and the buy side. And I look forward to the afterlife. I wish you all the best. Thank you very much.

Operator:
Ladies and gentlemen, this concludes Chevron's Third Quarter 2017 Earnings Conference Call. You may now disconnect.