4Q17 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 fourth 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 fourth-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. Mike Wirth. Please go ahead.

Mike Wirth (Chairman and Chief Executive Officer, Chevron Corporation):
Thank you, Jonathan. Welcome to Chevron's fourth-quarter earnings conference call and webcast. On the call with me today are Pat Yarrington, Vice President and Chief Financial Officer, and Frank Mount, 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.

Moving to slide 3, this is a scorecard outlining performance against our 2017 commitments. We had a good year and accomplished what we set out to do. We met our objective to get cash balanced. In fact, we were cash balanced without relying on proceeds from asset sales.

We stayed below budget on capital spending and continued our downward trend in operating expenses. We grew new high-margin production consistent with our guidance. We realized value from asset sales, with proceeds of more than $8 billion over 2 years, above the midpoint of the target range. And we ended the year within the debt range we predicted. 2017 was a very successful year. We are proud of our progress and we intend to build on this momentum in 2018.

Moving to slide 4. As you can see from the bar chart, 2017 cash flow including asset sales and before dividends grew more than $17 billion from 2016.

Some of this growth was a result of rising prices and some was from an increase in asset sale proceeds, but the majority was due to specific actions we took to improve cash generation from our operations. And the result: we were cash flow positive without asset sales in 2017, a full year earlier than our commitment, with a little help from prices. And we enter 2018 with strong momentum.

We know who owns our stock and what they expect. Our number one financial priority is to maintain and grow the dividend when we can sustainably support the increase with cash flow and earnings. That's why earlier this week, we announced a dividend increase of $0.04 per share, putting us on track to make 2018 the 31st consecutive year of increased annual per-share dividend payout.

With that, I'll turn the call over to Pat, who'll take you through the financial results. Pat?

Pat Yarrington (Vice President and Chief Financial Officer, Chevron Corporation):
Thank you, Mike. Starting with slide 5, an overview of our financial performance. Fourth-quarter earnings were $3.1 billion or $1.64 per diluted share, while 2017 full-year earnings were $9.2 billion.

In the quarter, we had two special items. We recorded a non-cash provisional gain of $2 billion related to US tax reform. We also recognized a non-cash remediation charge of $190 million associated with a former mining asset. Foreign exchange losses for the quarter were $96 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 for the quarter totaled $1.4 billion or $0.72 per share. For the full year, earnings on this same basis totaled $7 billion.

Full-year cash flow from operations was $20.5 billion. Cash flow from operations for the quarter was $6.2 billion, reflecting strong upstream production and higher realizations. Downstream results were noticeably lower than in the third quarter and I will say more on that in just a moment.

Excluding the $2 billion deferred tax provision I just mentioned, the three items we have called out all year as headwinds to cash flow -- meaning, changes in working capital, affiliate dividends less than earnings, and deferred taxes -- aggregated to around $3 billion for the year. For the quarter, these components represented a tailwind of approximately $350 million, in large part because of working capital effects.

In the quarter, we had a noticeable increase in international income taxes payable. For the full year, working capital was a minor benefit. Return on capital employed for 2017 was 5%. Our debt ratio at year-end was 21% and our net debt ratio was approximately 18%.

During the fourth quarter, we paid $2 billion in dividends. You are already aware that we announced an increase in our quarterly dividend to $1.12 per share, payable to stockholders of record as of February 16. We currently yield 3.6%.

Now on slide 6. Slide 6 compares full-year 2017 earnings with 2016. Full-year 2017 earnings were approximately $9.7 billion higher than 2016 results. Special items, primarily US tax reform gain of $2 billion, lower impairments and other charges of $1.9 billion, and increased gains from asset sales of $1 billion benefited earnings by $4.9 billion. A swing in foreign exchange impacts reduced earnings between periods by $504 million.

The passage of tax reform legislation in late December required that we revalue our net deferred tax liability to reflect the new, lower 21% tax rate. Earnings impacts from this adjustment are evident in all three of our reporting segments. And again, I will refer you to the appendix for the detailed segmented information.

Upstream earnings, excluding special items and foreign exchange, increased by about $5.1 billion between periods. Higher realizations, increased volumes, and lower costs were partially offset by higher DD&A, which was mostly associated with increased production.

Downstream results, excluding special items and foreign exchange, increased by just under $400 million. Higher margins were partially offset by lower volumes and lower earnings from CPChem, mainly due to the impacts of Hurricane Harvey.

Full-year 2017 “Other” segment results were in line with our guidance. Our 2018 guidance for the “Other” segment is $2.4 billion in net charges. This includes approximately $600 million of interest expense that was previously capitalized and $300 million worth of incremental tax effects, as net charges are deducted at the lower rate post-US tax reform. As a reminder, our quarterly results in this segment are non-ratable.

Turning to slide 7. We are aware of the challenges of modeling an integrated company like Chevron, and in particular, modeling downstream results in a quarter where oil prices rose as fast as they did. I'd therefore like to provide some additional commentary.

Our downstream margins were squeezed by rising feedstock costs. We estimate this adverse margin effect between third quarter and fourth quarter to be about $500 million across our operations, but specifically on the West Coast, where we have two of our three main US refineries. Industry refinery utilization in PADD 5 was very strong during the second half of the quarter, leading to abundant supplies and putting even greater pressure on margins.

We also experienced adverse impacts from two hurricanes. We estimate a further $190 million penalty from these relative to the third quarter. I am referencing both Hurricane Nate at Pascagoula, where a precautionary shutdown was taken, and Hurricane Harvey, which flooded CPChem's Cedar Bayou plant.

While the hurricanes were known to have hit our facilities, sizing the financial impact would have been difficult. I'd note that these fourth-quarter impacts are not structural, they are transitory, and we believe the fundamentals around demand, supply, production, prices, and margins for refined products and chemicals are positive for 2018.

The other segment for the quarter was a sizable negative, but the full-year charges were aligned with the guidance I gave on the third-quarter call. And lastly, but very importantly, we had very solid results in upstream in the quarter. A strong operating performance was complemented by rising prices, and both favorable elements are expected to continue in 2018. As you know, our earnings and cash flows are highly leveraged to crude prices and this leverage is expected to grow as our production grows in 2018.

Turning now to slide 8. Slide 8 illustrates 2017 production of 2.73 million barrels a day, an increase of 134,000 barrels a day, or 5% up from 2016. Major capital projects increased production by 240,000 barrels a day as we started and ramped up multiple projects, including Gorgon and Angola LNG.

Lower planned turnaround effects, primarily at Tengiz, favorably impacted production between periods by 34,000 barrels a day. Shale and tight production increased 46,000 barrels a day, primarily due to the growth in the Midland and Delaware Basins and the Permian.

Base declines, net up production from new wells, such as those in the Gulf of Mexico and Nigeria, were 45,000 barrels a day. PSC effects reduced production by 68,000 barrels a day as rising prices and lower spend reduced cost recovery barrels. The impact of asset sales, mainly in the US Gulf of Mexico and Mid-Continent, reduced production by 66,000 barrels a day.

I will now turn it back to Mike.

Mike Wirth:
Thanks, Pat. Turning to slide 9, reserve replacement is a real success story. As this chart shows, over the last five years, we have added about 400 million more barrels than we produced and divested.

Our reserve replacement ratio was 155% in 2017 and 107% over the last five years. We are especially pleased with this outcome because it was achieved on top of growing production last year. Our reserves to production ratio stands at a healthy 11.7, demonstrating the strength and sustainability of our business.

In 2017, the Permian was the largest contributor to reserve additions, where we continue to lower our cost structure, focus our investment, and develop our resources in a capital efficient manner. As we continue to ramp up our rig fleet, we are confident this pattern should continue. We also saw significant adds elsewhere across the portfolio, including from the Gorgon project, where well performance has been encouraging.

Moving to slide 10, this chart shows the continued progress we've made on spend reduction. As you can see, capital and operating expenses were down again this year. 2017 C&E spending was $18.8 billion, down $3.6 billion from the prior year and more than $21 billion from 3 years earlier.

2017 full-year operating costs were more than $1 billion lower than 2016, despite higher upstream production. When compared to 2014, we're down by nearly $6 billion. I expect us to maintain capital and cost discipline.

We are improving work processes, negotiating better rates from contractors and vendors, and becoming more efficient in all that we do. And technology offers opportunities for even more. We are in a cyclical commodity business. Capital discipline always matters. Costs always matter.

Now to slide 11 and asset sales. This chart shows asset sale proceeds of $8 billion over the last 2 years, with $5.2 billion coming in 2017. The two-year total is above the midpoint of our guidance range of $5 billion to $10 billion. Moving forward, we'll continue to optimize our portfolio where appropriate, using proceeds to support stronger asset and shareholder returns.

The criteria for divestments is straightforward. We'll plan to sell assets that don't have a strategic fit or won't compete for capital and are worth more to someone else, and when we can receive good value.

We don't discuss specific assets until we are into a transaction. We have one of these underway: the sale of our Southern Africa refining and marketing business, which is expected to close in 2018.

Moving to slide 12, our Australian LNG assets are becoming strong cash generators, with cash margins of more than $30 per barrel at $50 Brent price. Currently, four trains are online and running well. Well performance for both projects looks good.

During the fourth quarter, we completed pit stops on Gorgon Train 1 and Train 3 to improve reliability and increase production. Gorgon's average January production was 449,000 barrels of oil equivalent per day, up 86,000 barrels from the fourth-quarter average on a 100% basis. During 2017, Gorgon shipped 170 cargoes.

At Wheatstone, during the fourth quarter, we started Train 1, reached design capacity, and successfully addressed the commissioning strainers, which is a standard part of commissioning this type of LNG plant design. Wheatstone Train 1 average January production was 86,000 barrels of oil equivalent per day on a 100% basis. First LNG for Wheatstone Train 2 is slated for second quarter 2018, with startup for Wheatstone domestic gas the following quarter.

Now let's go to the Permian on slide 13. Production in the Permian continues to exceed expectations as we drive further efficiency gains and improved well performance. In the fourth quarter, we produced approximately 205,000 barrels per day, up approximately 60,000 barrels per day from the same period in 2016. Full-year 2017 production averaged 181,000 barrels per day, up 35% over the prior year.

We are currently operating 16 rigs in the basin and plan to end this year with 20 Company-operated rigs. And in support of our development program, we are currently employing six pressure pumping crews. I will update you on progress to optimize our land position in the Permian on slide 14.

In 2017, we enhanced the value of our position by transacting more than 60,000 acres through various swaps, joint ventures, farmouts, and sales. These transactions improve capital efficiency and create value by consolidating land positions, allowing longer laterals and other infrastructure efficiencies.

Last year's transactions enabled nearly 600 additional long laterals to be added to our well inventory. We intend to continue this activity to consolidate our land positions and optimize the value of our future developments. We'll provide further information on the Permian at our Analyst Day in early March.

Now let's move to the overall production outlook on slide 15. For this year, production at $60 Brent is expected to be 4% to 7% higher than last year, excluding the impact of any 2018 asset sales. Growth is expected to be driven by LNG in Australia, shale and tight, particularly in the US and Canada, and other capital projects. Partially offsetting that will be full-year impacts of 2017 asset sales and base decline.

The forecasted production range reflects the uncertainties associated with startup timing, rates of production, project ramp-up, base decline, and external events. In summary, we anticipate another year of strong production growth.

Moving to slide 16, we've had a number of recent developments that I'd like to acknowledge. Earlier this week, we announced a major discovery in the US deepwater Gulf of Mexico at Ballymore. This discovery has 670 feet of net oil pay with excellent reservoir and fluid characteristics. And importantly, it's close to our existing Blind Faith platform. We are currently drilling a sidetrack well to further evaluate the extent of the resource.

Also this week, we confirmed a major discovery at the Whale prospect in the US Gulf of Mexico, where we're a 40% partner. This find is approximately 10 miles from the Perdido platform. These discoveries are exciting for both their resource potential and their proximity to existing infrastructure, which offers the possibility for faster and more capital efficient development.

Also this week, we, along with our partners, were successful bidders on a large deepwater block in Mexico, adding to our position there.

And, installation is underway at Big Foot. We've installed seven of the 16 mooring tendons. On Tuesday, the tension-leg platform sailed from the dry dock facility in Ingleside, Texas. First production is forecast for late this year.

In downstream, CPChem reached mechanical completion of the Gulf Coast cracker in December and has begun the process of commissioning. We expect to start up later this quarter and reach full production in the second quarter of 2018. You'll recall that the derivative units achieved first production in September of last year.

Finally, on tax reform, we believe the new legislation is good for business and for consumers. It is a positive for Chevron, making attractive investment opportunities in the Permian, the Gulf of Mexico, and in our US downstream and chemicals business look even better. Our US capital and exploratory spend is expected to be approximately $8 billion this year and some $25 billion over the next 3 years.

Moving to slide 17, I'd like to share a few closing thoughts. Over the last decade-plus, I've had the opportunity to get to know many of you. I've been listening and your input has been helpful as I move into my new role.

I'm guided by my background, experience, and a few core beliefs. I grew up playing sports and I like to win. I intend to lead Chevron to win in any environment. To win, you need to have clear convictions. Here are some of mine.

We must be disciplined and returns-driven in capital allocation. Our cost structure needs to improve further. Costs always matter. We can get more out of the assets that we have as we can operate them better and more reliably.

We can optimize across the entire value chain to capture more value. And we need to continue to high grade our portfolio and our resource base to build the assets to win today and tomorrow, not yesterday.

For those of you I know, I look for to seeing you more in the coming months and years. For those of you I don't, I look forward to meeting you. I'm committed to continuing to grow cash flow, improve returns, and deliver value to our shareholders.

That concludes our prepared remarks and we'll be happy to take your questions. Jonathan, please open the lines.

Operator:
(Operator Instructions) Our first question comes from the line of Phil Gresh from JPMorgan.

Phil Gresh (JP Morgan):
Good morning. Congratulations, Mike.

Mike Wirth:
Thank you.

Phil Gresh:
So I guess I will start with -- I have one for Pat and one for Mike. So Pat, you talked about these moving pieces around CFO [cash flow from operations] items, these transitory factors that have been going on throughout 2017. And I was just curious how you think about 2018 with those factors: deferred tax, working capital, equity affiliates. Does that continue to be a headwind? Does it dissipate in any way?

Pat Yarrington:
The short answer would be to a large extent, there will be some continuing factors. The largest single component would be the difference that we expect between affiliate earnings and affiliate dividends.

The harder one to predict, clearly, will be what's happening on the deferred tax side of things. That will be very price-dependent. And then, of course, working capital is always very hard [to predict] as well.

But if I assume that there's no change in working capital -- just assume prices at the beginning of the year are the same as at the end of the year, and our activity levels are relatively flattish -- so no impact from working capital; and I put the the other two components together -- the affiliate distributions versus earnings component as well as an estimate around deferred taxes -- I would say somewhere on the order of $2.5 billion to $3.5 billion worth of headwinds would be the best estimate.

But I reserve the right at any time to come back and tell you a different number if prices are significantly different than where they are today.

Phil Gresh:
I understand. I appreciate that. Mike, just on your final remarks that you made, appreciate those. I guess my follow-up to that would be we saw a nice hike in the dividend: $0.04 [per share].

And as we think about the cash flow profile for the Company heading into 2018 at current price levels, it seems like you'd have a lot of excess cash. So, any additional thoughts you could share with us about how you think about deploying that cash? Is there room for buybacks if prices hold where they are?

Mike Wirth:
The first thing I'd say is our priorities have been consistent for quite some time and I have no expectation that those will change. Dividends come first. And I'm pleased that the Board has a confident view of our future and was willing to authorize the increase you just saw.

Reinvestment in the business -- we've talked about that. And we've got our budget outlined and a good program underway this year. The third [priority] is balance sheet and we've gone from having relatively, for us, higher levels of debt down to the lower end of the range that we'd indicated further. And then of course, historically, when we've had cash surplus to those needs, we have bought back shares.

So I think we will continue to be consistent in those priorities. It's always a balance across all of those. And we've really been in a period where we've seen three years of declining or unexciting commodity prices and three months of encouraging ones.

I think it's a little premature to get ahead of ourselves on this. But the dividend increase was certainly a signal that we feel good about where our business is positioned -- the fact that we are cash balanced. And if we continue to be in a constructive environment, obviously we will have cash to balance across all of those priorities. So more to follow.

Phil Gresh:
Okay, thanks, Mike.

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

Doug Leggate (Bank of America Merrill Lynch): Thanks. Good morning, everybody. And Mike, congrats on officially taking the reins and getting on the call this morning. I have two questions; I guess one is kind of a follow-up to Phil's. And it really relates to the strong performance in the Permian.

You've kind of positioned the Permian in the past as something of an offset to base decline, but obviously it's a pretty strong growth asset in its own right. Is that how we should think about the Permian as basically a means of resetting your sustaining capital? Or should we think about it as something that can actually become a bit more of a top-line growth engine for the Company?

Mike Wirth:
I think if you look at it on its own, it clearly is a growth engine. The nature of the activity is more aligned with what you would traditionally think of our base business. It's ongoing drilling of wells that individually carry with them a low risk profile that are relatively quick to execute. And it's the kind of thing that over time you can flex up or you can flex down.

I think it has been useful for people to think about putting base and shale and tight together. Their operational characteristics, their flexibility, the cycle time, and the risk profile have more in common than our base business does with the really large major capital projects that we've had. So I do think you can think of them together.

We've done a really nice job of mitigating our base decline on its own. And then when you add the shale and tight with it, the growth there is actually -- and you can see [in the chart] on slide 8 -- greater than the base decline.

We've got low risk, very predictable, flexible, and controllable growth offsetting that base decline and giving us a strong foundation as we move forward that just has a very, very different risk profile than a long-cycle major capital project where there is a big bang at the end, but there's a greater latency period.

We'll certainly talk more about this in March, but I think it's one of the fundamental shifts in the outlook for our Company. I think it is a fundamental shift in the risk profile and the variability around our cash flows. And frankly, it underpins a really good story as we move forward.

Doug Leggate:
I appreciate the full answer. My follow-up is really harking back to the breakfast you hosted in December. And it really relates to, I think, a comment you made about the culture of cost reduction from other parts of the business hadn't really, and not to put words in your mouth, but hadn't translated into E&P -- during a period of growth, obviously.

So I'm just curious. Are you happy with the cost structure in the E&P business and the maturity profile of the underlying portfolio? And I guess it's a roundabout way of saying should we expect another reset in the asset sales program as we go forward? And I will leave it there. Thanks.

Mike Wirth:
There's a couple of things there -- cost culture and then portfolio. The entire industry, as commodity prices surged and then stayed strong for a long period of time, had incentives to try to capitalize on that. And there's no doubt that the cost structure within the industry grew as a result of that.

Most of my working life has been spent in a part of the business where those periods of time are infrequent and short in duration. So I come from a mindset that you always have to be looking at costs. And in particular, you need to be very cost-conscious at a time when external conditions are incenting you to be less so.

And so I think that being focused on efficiency throughout the cycle is one of the keys to success. I tried to make that point in my closing remarks.

Our upstream business has done a fantastic job in getting their costs down, and I'm really pleased with what I've seen and what's been accomplished. There's been great progress. I mentioned $6 billion in spend reductions over the last few years.

I think going forward, the challenge is how do we sustain that momentum. And there's an opportunity to continuously focus on this, to challenge everything that we do for more efficiency, and to look at technology, which I think can unlock a lot of cost reduction.

We can leverage some of the things we are learning in our Permian activity and our shale and tight activity and ask how does this apply across other parts of the business. It's a long answer to saying yes, I expect us to continue to work on costs, irrespective of the external environment.

When I moved to portfolio, I made a comment about focusing on those assets that are the ones that will allow us to compete and win today and tomorrow. And I do expect us to invest in those things that we think are the assets that will be highly competitive as we move into the future. And to test ourselves on the things that may have been important in our past and may still be or may not be as we go forward.

The last couple of years, our asset transaction activity has been in part, at least, driven by the intent to get cash balanced. As we move forward, it's driven more by the intent to ensure we've got a portfolio that's highly competitive, delivers strong returns, and is set up to compete in the future.

Doug Leggate:
I guess we'll wait on the Analyst Day. Thanks, guys.

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

Neil Mehta (Goldman Sachs):
Thanks and congrats, Mike. I actually want to follow up where you left off there on the asset sales program and any early thoughts on 2018. You have been through a two-year pretty substantial divestiture program. Fewer things on the docket, it seems like, in 2018. So how should we think about what the new normal is for divestitures?

Mike Wirth:
Neil, I think you should expect us to continue to monetize assets where we can get fair value and they are worth more to someone else than they are to us. We have had a number of transactions and you have seen many close.

The Gulf of Mexico shelf exit was one where those assets have some running life ahead of them. Within our portfolio, they'll struggle to compete for capital. In somebody else's portfolio, they'll draw capital and investments and continue to create value for that company.

We have other assets that could fit that profile. So, I think when we get to our Analyst Day in March, we will probably speak to this a little bit more. But my view is you can't fall in love with your portfolio. You have to constantly challenge whether or not it will compete in the future.

You have to be willing to make moves to invest in the things that you believe are highly competitive, and be willing to face the realities on things that you are less likely to fund and potentially redeploy that cash into assets that strengthen your competitive position.

[It is] more of an optimization philosophy. It's what we've done in other parts of the business and it served us very well. And we will talk to you more about that as we have things that are ready to be discussed publicly.

Neil Mehta:
I appreciate that, Mike. And then in the slide, the 4% to 7% production growth in 2018 I think has been generally well received. It's still a relatively wide range relative to the base of production that you have. Can you talk about some of those uncertainties that could drive you to the upper end or the lower end of the range?

Mike Wirth:
Yes, I realize there's a bit of a range there. What we've done is try to reflect the realities that for project startups, you've got plans and you work hard to deliver those, but there can be some variability in startups and then you've got [pace of] ramp-ups as well.

The final thing that I would say is you do have unexpected events. We have experienced sabotage. The Partitioned Zone is still down and that was not something that was necessarily anticipated. We work in parts of the world that have challenging environments and things happen. So, there's a range. Clearly, we are working to deliver strong growth and would expect to be within that [production] range.

Over the years, we've ended up on Mr. Sankey's porcupine chart when we've gotten out over our skis a little bit. So, I'm trying to be sure that we can give you a range that we're confident in.

And in 2017, we gave you a range that was a little wider, maybe, than you would have liked. But we landed squarely in the middle of that. We're trying to reflect the realities that these things are not precisely forecastable, and showing you that we've got a strong commitment to deliver good production growth again this year.

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

Paul Sankey (Wolfe Research):
Well, thanks for that, Mike. And I guess I know what I am going to be publishing on Sunday as a chart. But firstly, congratulations. And I would like to second previous comments that we do greatly appreciate that you guys take the time to come on the quarterly call every quarter. So thanks for that.

Mike Wirth:
You're welcome.

Paul Sankey:
Mike, having said all that, there is a theme of the day, which is cash flows that you guys are generating. And you did mention cash flow breakeven or balanced. And when we look at oil at $60 for the quarter-ish, I guess we're totally perplexed by why cash flows -- and you've given an ex working capital number -- why cash flows are so low, given the move in oil.

Could you talk about where that's going to go next year? And whether if oil prices were to persist, what we would expect to see for cash flows versus CapEx from the Company? Thanks.

Mike Wirth:
Yes, so Pat has given you some of the pieces. And if she wants to try to go a little deeper, I will invite her to in a second. I've got to tell you, Paul, I'm very pleased and optimistic with the outlook for cash flow.

Our cash flow from operations improved every quarter during 2017. I cited a few of the things that are already evident this year, which are significantly stronger production in January at Gorgon, significantly stronger production already this year at Wheatstone, significantly stronger production in the Permian, and a price environment that you've just described.

The downstream issues that we faced in the fourth quarter are not structural, they are not repeating. Hurricanes happen, but they tend not to hit the same places every year. And margins in the business can ebb and flow. We don't have structural issues in the downstream at all. Our downstream has been a strong contributor of earnings, returns, and cash flow for many, many years.

I used the word momentum a couple of times in my remarks. And we, in fact, do have momentum in cash flows. We've got growing production. The production we're bringing online is cash flow accretive. I mentioned that our LNG out of Australia is $30 cash margin at a $50 Brent price. Obviously, we're above that [Brent price] today.

All the fundamental drivers of cash flow are moving in the right direction. There's a few headwinds, which Pat touched on. But the fundamentals here are very strong and those are what I'm focused on. So, I feel good about 2018.

Paul Sankey:
Yes, Mike, just quickly to follow up, could you just reiterate the 2018 balance aspirations? I think they were ex asset sales for cash flow versus CapEx.

Mike Wirth:
We said we would be cash balanced in 2018 without asset sales at $50 Brent. Clearly, if we have a year that's above $50 Brent, we will be better than cash balanced without asset sales.

And you also mentioned capital in there, Paul. Let me just touch on that. We've got a capital budget and that capital budget is driven by a program that will deliver the results I just spoke to.

We don't budget based on the oil price of the day. We've got a longer-term view on commodity prices, and we set our plans based on those views, not the then-current oil price. The fact that we're enjoying a little bit better commodity price environment as we sit here today is not something that's going to change our capital plans or our capital budget.

Operator:
Our next question comes from the line of Jason Gammel from Jefferies.

Jason Gammel (Jefferies):
Mike, let me add my congratulations as well. Just want to go to the chart on -- excuse me, the graph on chart 13 that depicts the Permian production. And the actual production is clearly way ahead of the type curves that you've got laid out, and that's with 16 rigs. And conscious you're going to be going to 20.

So other than Bruce Niemeyer getting a well-deserved promotion, I was hoping that you might be able to come up with some of the factors that have led to this out-performance. And realizing that you are not going to necessarily change the curves until at least March.

Mike Wirth:
What I would say is it's just been a focus on the fundamentals. We've used technology to better assess seismic attributes and to better understand the resource. Our petrophysical modeling continues to improve.

We are using new technologies to control drill bits and improve the precision of our lateral placement. There is a new basis of design where we change well spacing and, optimize our sand concentration per stage. We've increased the number of stages. We've got tighter perforation. There is a continuous optimization process in place.

I will just tell you the same thing that Bruce and others have reiterated which is that we not only learn from what we are doing, but we are bringing the learnings from joint venture partners and others that we see and we're rapidly applying those to improve performance.

Our costs are going down, our productivity is going up, our recoveries continue to grow. And I don't think we've seen the end of the improvement curve here. We are finding more efficiencies. Our development costs this year are lower than our target was [for 2017]. Our target for 2018 is lower than it was in 2017. And so we expect to see continual improvement.

For those of you that visited the Permian last year, I think you heard our people describe what they called the Frankenwell -- the perfect well. We continue to redefine what that looks like and redefine what good looks like.

So, this is a story that when you match it up with our large land position, which we are optimizing -- I talked about that -- building a deeper inventory of long lateral and highly efficient acreage for us to get after, we also leverage our ability through the midstream and downstream to add value and create more margin. On top of that, you consider our advantaged royalty position, this is an asset that I expect to continue to get better.

We will talk about that more when we see you in March, and we'll update some of the guidance that we've given you on what to expect.

Jason Gammel:
Look forward to that. And as my second question, Mike, just looking at the capital allocation for 2018 to the base upstream business relative to 2017. And this excludes the shale and tight allocations.

Base business allocation is down by about 25% year over year. It doesn't look like your assumptions on the base decline curve have really changed, however. So could you talk about some of the factors that you are seeing in the base business that is leading to the lower capital allocation with a similar expected result?

Mike Wirth:
You are right. We do have lower capital going into the base business this year. Some of that is simply driven by what the opportunity set looks like there and what the opportunity set looks like in the Permian.

Like I said, we've done a really nice job across a lot of our producing assets in holding base decline at pretty flattish levels. So, the efficiencies that I've talked about in the Permian are the kinds of things that we're seeing across the entire base business.

We've taken cost out of the supply chain. We've improved the efficiency and productivity of operations. At times, some of the [investments] in the base can be [things like] deepwater infill drilling, which tends to be a little bit bigger dollars. As those programs ebb and flow, that can cycle the base business [spend] a little bit as well.

But we're in a range here as you look at it that says we can keep our base pretty flat at relatively manageable capital spend. You put the Permian on top of [the base] and you look at the combination of those two elements and you say we have a base load of capital that can keep production flat or slightly growing. That is a relatively modest capital relative to the size of our Company. We'll talk more about the sustainability and what you can expect on that when we see you in March.

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

Paul Cheng (Barclays):
Mike, may I add my congratulations to you. And also I just want to echo what Sankey has said. Really appreciate you guys coming on to the call from time to time. I hope that at least one of your other major competitors will do the same.

Two questions. First, Mike, in the coming months, I will assume you are going to go and visit all your internal people around the group. During those visits, what is the number one and number two message that you want to send to them in terms of where you think you may need more effort, whether it's in certain practice or culture? And where you want to sharpen the focus.

Mike Wirth:
Thanks, Paul for the kind words and the question. I do intend to get out and about and see people and deliver some messages. The first one is that it's been a rough few years for people, particularly in our upstream business. And we've weathered that storm.

And so the message is simply: thank you for what you've done to put us in a position now where we're cash positive going forward without asset sales. We've taken a lot of costs out of the business and [our people have] worked hard to do that.

I've touched on a couple of themes already. One is we have to be prepared to win in any environment. And I think that's particularly important as you start to see a little recovery in oil price that we not think that the hard work is over.

We've got to focus on returns. We still have returns that need to improve. And we can't count on market to do that, so we've got to keep focusing on self-help. That means we find efficiencies in everything we do. We [need to] challenge our portfolio, some of the things that I've talked about. We've got to win in any environment. We've got to improve returns.

I think another area is to focus on the things that really matter. Big companies can sometimes try to do everything, and there's a few things we can focus on that will really drive performance. We need to execute, and that means capital projects. We need to execute on cost management. We need to execute on our safety and reliability initiatives.

And then the third one is how do we bring more technology into our business. You look around, and technology is changing the world. We've got lots of digital technology applications that are springing up all over our business. I'd like to see that happen faster.

I think there's more that we can do with technology. I think it can drive further efficiencies in our cost structure. I think it will drive further productivity in our assets. I think it can help us mitigate operating risks.

And so I will talk to them about how do we continue to find ways to leverage technology to further improve performance. Those will be some of the key messages that they will be hearing from me.

Paul Cheng:
Okay. The second question is that on the US onshore market clearly on the long and low basis, we are seeing cost inflation. Just want to see whether you believe your productivity gains will be more than what could be fully offset and so your unit costs will be essentially flat?

And outside the US, I think the service cost, doesn't seem like on the spot rate is dropping. But should we assume that your overall unit cost may still be dropping because you have other contracts maybe rolling over?

Mike Wirth:
Yes, Paul, you touched on an important point. That's one of the questions a lot of people are asking, which is are we going to see cost inflation. I'll tell you right now, as we go around the world and we engage in sourcing exercises, we are not seeing evidence of strong cost inflation really anywhere.

Now you mentioned the Permian. I'll come back and talk to the Permian in a minute. But we really are continuing to find opportunities to hold or even improve costs as we look around the world.

In the Permian, there's more activity picking up, so you can expect that there's talk of that [cost inflation]. Two-thirds of our spend in the Permian is protected with contracts right now. Those contracts have been negotiated before we went into this year.

We've got a philosophy of managed competition there to lock in [rates]. And with our size and leverage, we're an attractive baseload for a number of these suppliers. So, we've locked in good, fixed pricing in much of the portfolio. Some indexed pricing, so if there's certain indices that move, we will accommodate that.

And then there are incentive contracts, where if some of our service providers can meet performance benchmarks that drive our costs lower, there is some sharing of that [success] as well. So, we are focused on ways to continue to improve our cost position there.

And the efficiencies in activity and productivity that we've seen in recent times have amplified reductions in input costs. If you start to see input costs level out or even turn a little bit, I still expect further improvements in productivity and efficiency will offset that.

We could see some very modest – and I'm talking single digit -- overall increases within the Permian. But to step back to our whole portfolio, we've got growing production. And we are not going to allow costs to grow at the rate that production is growing. So, from a unit cost standpoint, you can absolutely expect that we're still focused on driving unit costs even lower.

Operator:
Our next question comes from the line of Alastair Syme from Citi.

Alastair Syme (Citi):
Thank you and hello, everyone. Mike, one of your peers has recently suggested that SEC reserves are becoming a less meaningful metric for the industry. And obviously, this is a metric that Chevron has scored very highly on in recent years.

So can I get you to offer your perspective on how you look -- as you look closer into the E&P business, how you view reserve life as a management KPI? And whether you think there is an optimal reserve life for the business to be running?

Mike Wirth:
Yes, we respect the SEC's roles in the reserve process. We are very diligent in setting up our own internal approach to reserves to be sure that we have the right checks and balances. And I'm not going to suggest the SEC reserves rules are anything but something that we understand and comply with. And they are, I think, a consistent benchmark for investors to use to evaluate companies.

Like many things, you can argue are they perfect or not, but it's a consistent benchmark and we all use it. So, I think it's useful.
I believe stability in reserve life is good. If you see reserve life growing, it's either a sign that your production is declining or that you are investing prematurely or too much. If you see the reverse, where reserve life is declining, it starts to raise questions about sustainability, about the need to go out and spend money to acquire resource.

To me, stability is the key. We have had a good, stable R-over-P [Reserves over Production] ratio here for the last many years and continue to add our reserves primarily through organic activity. I talked about the reserve adds this year being driven by the Permian and Gorgon. Those are big contributors, and those are certainly contributors that we can see out into the future where we would expect [them] to play a part in extending reserves life as we go forward.

I think each company has got their own particular set of circumstances, and I will only comment on ours. I think we are in a good, strong, and sustainable reserves position.

Alastair Syme:
Brilliant. Thank you. That's very, very helpful.

Operator:
Our next question comes from the line of Blake Fernandez from Howard Weil.

Blake Fernandez (Howard Weil):
My congratulations as well. Back, I guess, right on that reserves topic. Maybe Pat, this is a question for you. But given the nice increase that you saw this year, is it fair to think that DD&A rates have potential to move lower as a result of that?

Pat Yarrington:
Yes, I do believe that. I don't have an order of magnitude for you at the moment because we are just finalizing that. You'll note that the numbers we put out are preliminary and we're tying that down between now and when we publish the 10-K later in February. But yes, directionally, that will happen. We will have lower DD&A rates.

Blake Fernandez:
Perfect. The second question is on the, I guess, recent discoveries you have had. Both look pretty attractive and look like they have fast-track potential. Given the focus on short cycle the past 12 to 18 months or so, obviously, you haven't sanctioned many projects, but these look promising.

I guess I'm just trying to understand the timing of when you could look at sanctioning that and how that would fall into the capital program. And I guess what I'm thinking there specifically is phasing with Tengiz. As Tengiz rolls off, could these kind of make their way in and hopefully not create a step-change in total spending?

Mike Wirth:
We're still appraising these discoveries. They are encouraging and we are very pleased with the first look and the proximity to infrastructure. But I think it's premature to jump into exactly when and how those would be developed, other than the proximity to infrastructure which opens up more capital-efficient development alternatives than you would not see if you were more distant from it. But more work to be done to be sure that these have been fully characterized.

I think to get above that a little bit, I would just say that we really believe that a more ratable C&E program is important. I think it helps us financially. I think it helps us from a standpoint of execution. And so, I think that the swings you've seen in our C&E spend are things that we'll try to significantly dampen out and stay in a more ratable band.

The last thing I would say is no matter how good this resource looks and how interesting it is, we've got a great option in our shale and tight portfolio. Other resource classes, and the Gulf of Mexico deepwater is a great example of that, need to get the costs down in order to compete for funding.

Our people know that's what they need to do to make these competitive within our portfolio for funding. And that's why I think the brownfield aspect of these is interesting. But they have to compete and they have to deliver attractive returns and economics relative to our other alternatives.

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

Ryan Todd (Deutsche Bank):
Great, thanks. Maybe another one on capital allocation. Post the tax reform, does the tax reform in the US impact the way that you think about investment at all over the next five years, either from -- in terms of an increase in cash flow or from an improved rate of return from associated or particular projects?

Or should we think that you will generally continue to err on the side of capital constraint? I guess how -- does it figure at all in terms of how you look at allocating capital over the next five years?

Mike Wirth:
We are still grinding through the real details of our specific position. And companies like ours have complex tax positions and so to get too specific about that, it is probably premature.

I would say that [tax reform] makes US assets and investments more attractive because they are going to be attracting a lower tax rate. And so, I think over time, as I said earlier, I think it's good for the US economy. I think it's good for US companies. I think it's good for investment in this country.

And we have significant assets here already and opportunities to invest in the future. So, we will grind through all of that and make sure that we get a clear understanding and guidance [of any impact].

The other thing, if you think about it through the other lens, is as we have assets around the world, some in fiscal regimes that have not changed for quite some time, whether it's in response to lower prices or the changes in the US tax laws, those investments become tougher to make, frankly.

I think governments around the world will, over time, have to evaluate the competitiveness of their fiscal terms relative to the options that a company like ours would have. We allocate our capital to drive better returns across a global portfolio. And so as these things move around, it's a competitive world and we need to acknowledge that, as do others.

Ryan Todd:
And then maybe a follow-up on the Permian. You've been relatively active and you have a slide in there on acreage sales that you've done over the past few years and expectations for 2018.

If you think about that program, I mean, would you characterize it as more of an effort to core up your position? Or is it an effort to pull forward to some extent kind of the long-term tail of the valuation, a mix of both?

And I guess kind of given your expectation of going to 20 rigs at year-end, you clearly have a very, very, very long resource life there. How should we think about your philosophy in terms of maximizing the value of the asset? Could you monetize more in terms of monetizing some of the tail or accelerating rig count? How do you look at maximization of the value of that resource?

Mike Wirth:
It's a good question. The real goal is to maximize the value of the resource position. And the largest driver by a significant amount is coring up acreage so that we can get longer laterals and the efficiencies that we continue to see out of our operations.

I mentioned we understand the resource much better today than we did 12 months ago and 24 months ago. And I think we will understand the resource better 12 months from now as we continue to use more and more sophisticated tools and gain more experience and insights into what makes it work.

As you have that kind of knowledge and you've got a large land position, we would intend to drive our portfolio to what we believe are the sweetest of the sweet spots and the positions that will create the most value over time. If that means some of it is what you would describe as further back in the queue and the right thing to do is simply to exit it for cash and redeploy into coring up today, that's certainly a part of it.

But it's a value-driven strategy for the 2 million acres that we have there. It's not driven by any intent to sell the tail alone. It's really to create value across the whole position.

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

Roger Read (Wells Fargo):
Thanks for sneaking me in here at the end. Good morning, everybody. Mike, if I could follow up a little bit on Ryan's question, you kind of talked about the Permian position there.

Is it easier, the same, or more difficult to do the swaps and exchanges? In other words, as everyone gets more comfortable with what they own, or are we seeing it where people are less certain what they own and it is slowing down some of the exchanges? I know you had kind of a 200,000 acre, 80,000 done so far. I'm just curious how that's progressing.

Mike Wirth:
What I would say, Roger, is this is one of those unique places where you can drive win-wins. Because of the way the acreage was defined over 100 years ago and the way it's been held over time and the [employment of] technology today with longer laterals and the value creation through that kind of a development program, it's in everybody's best interest to find ways to improve their position.

Oftentimes in commercial negotiations, you've got a win-lose. And that can create a tougher dynamic than one where both parties can realize value. And you sit down at the table and both have incentives to find a way to do a deal.

I would say we may, in fact, have been a little more difficult to deal with heretofore simply because of our ‘let's go slow to really understand what we've got’ approach to this. And whether you're talking development or you're talking land optimization, there's a lot of activity going on in the basin where we weren't necessarily engaged in as much of it.

Now that we are in a position where we feel like we really understand what we want and where we want to go and we are willing to deal, we've got numerous conversations underway with counterparties. And I think there is strong reason to believe that we’ll conclude further value-creating transactions this year and into the future.

Roger Read:
Okay, great. Thank you and I will see you next month.

Mike Wirth:
Okay. I know we are just a touch over time here, so I want to thank everybody for joining us on the call today. I truly appreciate your interest in Chevron and everyone's participation in the call. I look forward to seeing many of you in New York in a few weeks.

Jonathan, back over to you.

Operator:
Ladies and gentlemen, this concludes Chevron's fourth-quarter 2017 earnings conference call. You may now disconnect.