centrica

# Strategic partnership with Statoil and Norwegian asset acquisition

**Transcript – 21 November 2011**

**Sam Laidlaw**
**Chief Executive**

Well good morning everybody and thank you very much for making the time to join us this morning. As you will have seen from our announcement this morning, there are three separate parts to this important step for our upstream business and for the Group overall in the transactions we are announcing this morning.

Firstly a strategic partnership with Statoil to look at new exploration opportunities in Norway and the UK. Secondly of course bringing long-term supplies of gas to the UK. And thirdly an asset deal that gives us real scale to our Norwegian operations and indeed increases the scale of our upstream business as a whole.

The purpose of this call really is to give you some further colour around the transaction itself and what it delivers in terms of our strategy. Nick Luff and Mark Hanafin are here with me today and we have got a few short slides to walk through and then hopefully we will leave plenty of time for Q&A.

As I said, there are three elements to the transaction. If you go to slide 4, a 10 year NBP linked gas supply transaction boosting energy security for the UK. The acquisition of a package of assets just under a billion pounds, £965 million in the Norwegian North Sea. And this has a good mix of current production and developing assets and some exploration acreage which will substantially increase our scale in this key region for us going forwards. And the strategic element as I mentioned giving us the opportunity to partner on gas exploration activities in Norway and the UK.

And I would like to touch on each of these in turn. Firstly the gas supply contract on slide 5. This is a ten year agreement priced off NBP and it runs from 2015. As you are aware we have a current arrangement, an agreement with Statoil up until 2015. So this is a new contract from 2015 to 2025, providing 5bcm of gas each year and obviously that is very significant in terms of what it does for British Gas' customers, enabling us to supply some 3.5 million British Gas homes, but also it is very significant in terms of the UK's energy security as it amounts to about 5% of UK demand.

If we look at slide 6, the asset acquisition, the total consideration is just over 1.5 billion dollars, equivalent to the £965 million. With a further 100 million dollars payable over time dependent on the level of production at Kvitebjørn. So it is payable over the next four years dependent on how Kvitebjørn performs and Kvitebjørn is the main asset in the portfolio here. This total package gives us significant scale in Norwegian waters. I think it is an attractive focus portfolio. It gives us our first operating production assets in Norway and it provides a good long-term profile with strong existing production in Kvitebjørn which you can see at the top of the map and Kvitebjørn is just east of the Goldfax and Staffield fields with considerable future development potential with the Valemon field expected to come on stream in 2014. And further development potential from assets in the Heindle area. All of the current production is currently uncontracted and there is optionality around the export pipelines with the gas either coming to the UK at Easington or St Fergus or to

Germany at Dormun. I think it will greatly increase the size and scale of our Norwegian business. And if you look at slide 7 just to give you a sense of that, our reserves, overall we expect to book here some 117 million barrels of 2P reserves which increases our Centrica energy 2P reserves excluding the reserves we have in Canada and North America by some 30%. And trebles our Norwegian reserves. It also will significantly increase our current production by 25% to around 62 million barrels equivalent per annum or nearly 180,000 barrels a day.

Kvitebjørn is the largest asset in the package and it accounts for three-quarters of the 2P reserves being acquired underpinning a strong production profile with production for the field estimated to continue for as much as another 30 years. This truly is a long life asset. And in the development opportunities, the development field is expected to come onstream in 2014, comprising just under 20% of the total 2P reserves being acquired.

And looking further ahead, there is considerable exploration potential. I think in summary, this transaction gives us a very attractive, balanced, but long-term portfolio which will lengthen our reserve to production life.

If you look at the production profile itself on slide 8, you will see again this chart excludes our production and reserves in North America, but you will see what this does to enhance our production profile. And you will see at the bottom of the chart in the shaded areas our existing portfolio, a stable production profile for the next ten years of around 50 million barrels a year. And you will see at the top in the darker colours, the new production profile for the acquired assets stepping up to a new level of around 62 million barrels a year.  And here you will see for the existing production is shown in blue, which is largely the Kvitebjørn assets, the assets under development in orange which includes Valemon and future developments in green which steps up by around 2020 and represents significant potential value for the longer term.

In summary, this marks a significant step change in our production profile, both for the Norwegian business and for Centrica as a whole.  Greatly enhancing the portfolio with strong long-term production.

If you go to slide 9, in terms of the financials, the transaction is also attractive, not only in terms of the strategic position it gives us, but also in its own right. The assets generate strong cashflow, underpinned for many years and we expect through the existing production assets, but of course significant development potential as well. Over the life of the assets we would expect to achieve double digit IRR, with the potential to achieve more under high commodity price scenarios and with a step up in returns as the new developments come on stream.  The long-term nature of the package serves to increase our overall reserve life. And that has been a key objective in strengthening the CE portfolio and also helps us strengthen the energy hedge.

Above all, our objective is to deploy capital where we can see attractive returns and deliver both value and growth enhancing the scale and geographic diversity of our operations. And building on our existing capabilities and current position in the region. And these are all areas that we know well from our existing operations in Norway.

The final element of the transaction on slide 10 is the Memorandum of Understanding we signed with Statoil, clearly the leading player in Norway and one of the leading players offshore and clearly in the business of exporting gas. The MoU gives us the opportunity to partner on gas exploration activities in Norway and the UK, both on existing license opportunities and on new licensing rounds allowing us to work together on the best acreage opportunities. And we see this as a key component of the transaction, combining our expertise and further enhancing the long-term growth potential of both Statoil and ourselves.

I hope this gives you a sense of the scale of the opportunity the transaction brings and I think with that we would now like to open it up to questions please Claire.

**Questions and Answers**

**Q1. Bobby Chada, Morgan Stanley: Future exploration, 2020 production**
Thanks, good morning everybody. I have two questions please. The first is on the, you talked quite a few times about future development opportunities around the portfolio over and above the 2P number that you quoted. Will Centrica solely be in charge of assessing and exploring for those? Or do you have existing partners in the field you will have to work with?

And then the second question is, on slide 8 I think it is that shows the annual production across the portfolio, there is a big step up in future developments in 2020. Can you flesh those out a little bit please? And are those included in the 2P number of the 117?

**Answer: Sam Laidlaw**
Bobby thank you very much for the question. The first question was around the future development opportunities, will we be in charge of those? We see some upside in Kvitebjørn and Valemon, but we also see the opportunity of bringing Vale back on stream and also some opportunities in exploration and satellite developments around Frig. Those areas are really what is represented there in the green and those actually will be operated by Centrica. They are not included in the 2P number. Mark do you want to add to that?

**Further answer: Mark Hanafin**
Yes, the development comes from a combination, as Sam said, of fields that we will operate such as Fragamma Delta and Fuller, that is in the development area. But also developments around Kvitebjørn and Valemon that Statoil will look to exploit in terms of near field opportunities.We talked about the 2P reserves but there are around 42 million barrels of 2C resources, risk net resources that are part of the package and we have identified about 30 near field exploration opportunities in the two areas. The net risk prospective resources there are around 37 million barrels. Obviously we would heavily risk those, but that is where the upside opportunity comes from.

**Further Answer: Nick Luff**
And Bobby the green on the chart is from that 2C, it is not the 2P.

**Bobby Chada**
Great, thank you.

**Further answer: Sam**
If I could just come back. To build on Bobby's point. Not included in here. We have had good success in Norway with our exploration programme you know. Of the

seven wells we have drilled, four have been discoveries. We are drilling one at the moment. And you know we think, so that is again not included in these numbers.

**Q2. Jamie Tunnicliffe, Redburn: Capex**
Good morning. I just wondered if you could give any indication of the sort of capex that would be associated with the acquisition and then what you might spend on some of the developments and exploration as well?

**Answer: Nick Luff**
The capex depends on the individual projects and it is quite lumpy, but it generally goes around £100 million per annum over the next few years, sometimes above that, sometimes below. It does step up assuming we are successful with developing the 2C resources later on.

**Further answer: Sam Laidlaw**
We will be sharing more of this of course at our Capital Markets Day on 1 December, in terms of placing it in the context of our overall capital programmes.

**Jamie Tunnicliffe**
Perfect, thanks a lot.

**Q3. Lawson Steele, Espirito Santo: Payback period, nature of MOU**
Morning everybody. A couple of questions if I may. Could you give me an indication of how many years payback you anticipate for the project?

And I am not sure I was clear on the MoU, is that an exclusivity deal or just on the existing projects? Perhaps you could give a bit of colour on that for me please?

**Answer: Nick Luff**
We hope the payback takes quite a long time because that will mean we have been successful on the developments and have therefore put in more capital. Half the capital will come back in 4-5 years. After that it it will take a long time because we will be putting more capital into the development if it goes well. But if they are unsuccessful then it will come back quicker.

**Further Answer: Sam Laidlaw**
In terms of the second part regarding exclusivity, we have got more details to work out. It is not currently an exclusive arrangement, but I think as we zero in on particular opportunities that we want to work on together, we would expect it at that stage to become exclusive relating to those particular blocks and areas. And that is the way it normally works in this business.

**Lawson Steele**
Okay, thanks very much.

**Q4. John Musk, Royal Bank of Canada: Opex, energy hedge**
Good morning everybody. I have two questions, one is more numbers and one more strategic. On the numbers, can you give us an indication on the opex levels within these assets and how they compare to the all in lifting costs that you have currently got?

And then secondly, as we look to your energy hedge, around I think this gets you to I think speaking to the guys this morning, to around 85% overall, is that where you now see yourselves as being or should we expect further deals?

**Answer: Sam Laidlaw**
In terms of the opex, these are all lower despite the fact that there is considerable pipeline transportation tariffs involved here than our UK fields. So a number of something under £7 a barrel would be a good all in number here.

In terms of the structural hedge, you are right, on a pre-tax basis this gets us to 85%, but of course with the high tax rate, actually on an after tax basis, our hedge is only, and I am talking an energy hedge here, around 50%. If we can find opportunities I think broadly speaking this is where we need to be, but if we can find opportunities that actually are particularly value enhancing, we would be happy going a bit beyond the 50% on an after tax basis.

**John Musk**
Okay, thank you.

**Q5. Jamie Tunnicliffe, Redburn: Amortisation**
Yes just on the amortisation of the acquisitions bid, can you just mention how long that gets amortised and the sort of profile you would expect of that?

**Answer: Nick Luff**
That is a good question Jamie. Obviously what you have to do here is allocate the acquisition price to the individual assets and a quirk of accountings isn't an acquisition in a technical accounting sense, it is an acquisition of assets rather than a business. So you don't have any goodwill and therefore you do get amortisation of that acquisition which will mainly go against Kvitebjørn production. So over a number of years, but it is heavier in the early years and that does hold back the earnings, because it isn't tax deductable of course, whilst we get some tax allowances with this, the tax allowances don't equal the acquisition price. So that will hold back the earnings particularly for 2-3 years.

**Jamie Tunnicliffe**
Thank you.

**Q6. Johann Terry, Exane BNP Paribas: 2012 profits, price**
Good morning. Two questions please. The first one very simple, could you give us an idea of the adjusted EBIT and net profits in total for 2012 from this acquisition?

And secondly we calculate price pure reserves around $13. It is quite expensive compared to recent transactions and also compared to some indication Woodmac. Could you tell us what would explain such a high price and you are talking about a double digit IRR, due to lower opex compared to a similar transaction or is it due to the potential development of that field? Thank you.

**Answer: Nick Luff**
You want to get the full P&L account in your hands, is that right? We indicated the EBITDA from this should be, full year, between £400-500 million. Obviously 2012 will only be, assuming we complete around the end of the first quarter, three-quarters of a full year. There will be a £100 million or so of depreciation and amortisation of abandonment. You then have to apply quite a high tax rate to that, particularly in the

early years due to the acquisition cost not being tax deductable. So bottom line, in the early years it will more than cover us after tax costs of debt, but not by that much. So it will be accretive, but fairly modestly so.

**Answer: Sam Laidlaw**
I think your second question was a suggestion rather than a question, that it looked expensive. If you look at the recent transactions, actually, on a dollars per barrel and there is always as we all know, a great danger in using simplistic dollars per barrel metrics or even with Woodmac data, it actually is cheaper than I think six out of seven of the last transactions that have been done on a dollar per barrel basis, in the Norwegian North Sea. You know the exception probably has been where people have bought very short life assets with big dismantlement liabilities and the important point really is strategically with this asset is that these are long life assets, 75% of the reserves are in the Kvitebjørn field which as we said, has another thirty years of life and the Valemon field is developing. And some of the development money has already been spent on that. This is very different in terms of the length of reserves that we are buying here.

In terms of the assumptions that we are using of why this differs from Woodmac actually this is probably more around the technical due diligence that we have done and are familiar with some of these assets. We have been talking to Statoil about for a long time. We are now comfortable with the reserves here.

**Q7. Paul Spedding, HSBC: Tax**
Morning. Just a question on the tax front, as to whether there is any additional exploration tax field that you picked up that you may be able to take advantage of? And whether you might be able to give an indication of what the value of that could be?

**Answer: Nick Luff**
Well as you know, the Norwegian regime is quite favourable for both development and exploration spend. You get full relief at the 78% rate plus an uplift of an extra 30% spread over four years. So I am not sure we could put a number on that precisely, but once you get into the development phase, it does help quite significantly in terms of the overall cashflows.

**Further question**
If I follow-up and ask what you expect to be spending in exploration in Norway under the, with combined portfolio?

**Further answer: Sam Laidlaw**
I think that is something we will talk about more at the Capital Markets Day because what we will be doing is actually taking a holistic view across the Group with the higher level of production that we now expect to have as to what the right model for reserve replacement is going to be and the right level of exploration spend is going to be going forward. But we will come back to that on 1 December.

**Q8. Gus Hochschild, Mirabaud: De-commissioning liability**
Thank you very much, good morning. Just one question if I may please with regards to the de-commissioning liabilities of these assets. So the Group level, by how much should we increase that liability please?

**Answer: Nick Luff**

Again, we haven't got a precise number we can give you on that right now, but the Kvitebjørn doesn't, which is the main producing asset, doesn't get decommissioned until 2035 so it is some way off and by the time you discount that, it is not a big number today.

**Q9. Fraser McLaren, Bank of America Merrill Lynch: Balance sheet**

Good morning gentlemen. Just thinking of the Group balance sheet and the extent to which this deal may change your appetite for deals in North America and also capex on new nuclear?

**Answer: Sam Laidlaw**

Behind the question there was an implication that it will. I think the point is that this deal does not use a great deal of headroom. And Nick if you want to speak to that. We still see the opportunities of continuing to build the business in North America and also continuing to invest in new nuclear if the returns are there and demonstrated to be there.

**Further Answer: Nick Luff**

We will have to lay this out in a bit more detail at the full year results. I think you will have to start looking at Centrica's debt ratios in our after tax basis, because this deal actually has very little impact on us on a straightforward debt to EBITDA because the EBITDA as I mentioned is about £400-500 million against the acquisition cost of under a billion. So it doesn't really have that big an impact. Of course after tax, you have to take the tax off as well, it is more significant, but it doesn't use a massive amount of headroom, particularly if you look at it at the ratios that the agencies look at, like retained cashflow to debt ratios. It uses some, but not a huge amount.

**Fraser McLaren**

Many thanks

**Q10. Peter Bisztyga, Barclays Capital: Tax relief, Financing**

Hi, good morning. Two questions if I may. Firstly, could you just clarify just how much of the £100 million of capex that you will be spending in the early years you expect to get tax relief on?

And then secondly, can you just tell us how you are going to finance this transaction? Is it just going to be through existing credit resources?

**Answer: Nick Luff**

Peter, the answer to the capex question, how much tax relief? all of it. You get the allowances over six years typically in Norway on capex spend there and we have got sufficient profits to, including from the Kvitebjørn production, shelter all of that.

And in terms of financing, we could finance this out of existing resources that we have got from existing facilities, existing cash resources. We might look at whether there is an opportunity for us to put some longer-term debt against this in the bond market, but that is the sort of judgement we will make over the coming weeks and months.

**Peter**
Right. Thank you.

**Q11. Dominic Nash, Liberum Capital: MOU date of signing**
Good morning, just a simple question on the Memorandum of Understanding. When do you think you will be in a position to sign that? And do you think that, where do you think we could actually go to how aggressive a growth platform could this be for your ENP?

**Answer: Sam Laidlaw**
I mean the answer is we will sign the Memorandum of Understanding today. That is all part of it. That will then be the framework agreement that enables us to put the respective technical teams together and decide where we want to actually focus the effort. So it will be fairly general in the first instance and it will become more specific as we enter into discussions around exactly the areas that we think we want to focus on and Statoil want to focus on and where we can actually leverage our combined technical capabilities.

So the second part of your question is, how big could this be? I think clearly we see a lot of remaining potential on the Norwegian continental shelf. We think there are also some things that we can do together on the UK continental shelf too. So I think this could be a very important upstream alliance and we hope it will be.

**Further question: Timetable for agreement**
And the sort of timetable for the final completion, final agreement, is it going to take three months-six months to do?

**Answer: Sam Laidlaw**
No, I don't think you should think of it as, we are going to then have a sort of subsequent agreement that actually is locked into one or two areas. This will actually be an ongoing relationship where we will share expertise and share ideas on particular opportunities that we want to work on together. They may emerge in the next month or two or they may emerge in the next few years. You know, some hopefully in the next few months and others will take longer in gestation. You know, there is a lot of, there is clearly a lot to do in terms of sharing technical understanding and deciding which areas we really want to focus on. And there may be some areas that we want to work on jointly and there will be other areas where one or other party will be bringing their seismic database and we will take it from there.

**Further answer: Nick Luff**
And to be clear Dominic, the asset acquisition is a binding contract we signed this morning. That we expect to close towards the end of the first quarter.

**Dominic Nash**
Thank you very much.

**Further answer: Sam Laidlaw**
That is just subject to the normal conditions precedent which in this case is essentially Government approval.

**Dominic Nash**
Okay, thank you.

**Q12. Ashley Thomas, MF Global: Organic reserve replacement, Morecambe**
Yes, good morning. Given the greater focus on exploration and development now, I wondered whether you could give us a feel over what sort of time frame do we think the organic reserve replacement rates will move closer to the 100% level?

And my second question is actually a supplementary on Morecambe, but on the slide 8, obviously you have had lower output in 2011 due to commercial optimisation, sort of view on short-term oil and gas price move. But it looks like the output from 2013 onwards looks to be lower than that disclosed earlier in the year. So I just wondered whether that was a correct interpretation or not?

**Answer: Mark Hanafin**
Let me handle the first part of that question about organic replacement and reserves. We will be going through in quite a bit more detail on 1 December the maturation model that we have. We are starting from a position where we had very little in the way of growth potential in the business and a declining business. So from that low beginning in terms of reserve replacement potential, we have been growing the business. We will probably have a very good year this year in terms of reserve replacement. I am expecting that we will be able to replace all of our reserves the 50 million barrels that were produced this year, and that will be some drilling, but it will also be bringing 2C into 2P and upgrades in the existing 2P reserves. So obviously the numbers are still being worked.

**Further question: Reserve replacmement**
Sorry, so this year that may actually have been driven by the gas price move rather than internal company developments?

**Answer: Mark Hanafin**
Generally the model that we have where we are looking at a combination of exploration and acquisition in terms of growing reserves, typically we would be looking at around half of our production being replaced through the drill base and half through acquisition. But as I say, we will go through that model in more detail on the 1st.

**Further answer: Sam Laidlaw**
And just building on that I think we recognise that in the UK which is clearly a very mature province, the chances of replacing reserves consistently purely through exploration without actually potentially over-drilling and giving value back and drilling dry holes, I think that is a challenge. Norway I think is very different and we can find larger field sizes and accumulation sizes, so it is really when we put the two together we have a better chance of actually getting 100% reserve replacement purely through exploration, but my expectation is that we are still going to be doing some tactical acquisitions. And it will be an acquire and exploit model rather than a pure exploration and drill model which would have more risk to it.

**Further answer: Nick Luff**
And your second question, actually on Morecambe, it is not intended to be a correction or anything, we will have a look at it but it is meant to be in line with previous, it shouldn't have changed significantly but we will have a check.

I suspect it is just, it looks small these days. The scale on the chart has got bigger than it used to be.

**Ashley Thomas**
Thank you gentlemen.

**Closing Comments: Sam Laidlaw**

Well thank you all very much for your interest. I think you will hopefully see this is a big step forward for the Group as a whole for our upstream business and our Norwegian business in particular but also I think with the gas supply contract and the partnership, certainly a good proposition for our customers as well as for shareholders and for the UK's energy security.

So thank you all very much for your interest.

**End of Presentation**