Centrica plc 2017 Trading Update
Thursday 23 November 2017
8.00 am

Co-ordinator
Good morning and welcome to the Centrica Trading Update call. My name is Natalie and I will be your co-ordinator for today. You will have the opportunity to ask a question on today's presentation. I will now hand over to your host Iain Conn, if you would like to go ahead Iain.

Iain Conn – Group Chief Executive
Thank you Natalie and good morning everyone and thank you for joining the call this morning. I am joined here today by Jeff Bell, Martyn Espley and Rebecca Triffitt. And after a few introductory remarks by me I will then go straight to your questions.

I will provide some headlines at the beginning and try to set the scene. The first thing to say is that performance in the second half has been disappointing after a solid first half, but largely in energy supply in Centrica Business and as we have outlined in the Release, North America Business has been impacted by four things. Firstly, and actually they are all largely relating to the Retail Power Book which is one of our books in North America Business. So the first thing is that unit margins have been compressed throughout this year as a result of competitive intensity, particularly as a number of individual power producers have moved in downstream and we have seen significant competitive activity.

The second thing is volatility has been very low and as a result we have been unable to capture additional margin. Thirdly, and very importantly, the shape of the energy curve has been such that the business that we have been booking has resulted in the net margin that we have been booking in sales being compressed in the near term, even though it is likely to, the remainder of the margin will be booked in subsequent years. And then we have announced today a one-off non-cash charge of £46 million relating to a reassessment of the historic recognition of the unbilled power revenues and this goes over a five year period and Jeff will be able to take you into more detail on that.

So the North America business result that we are forecasting is significantly down for those four reasons. Some of it will come back in latter periods.

In the UK business we saw recovery in the second quarter, but have continued to see difficulty in our retention of existing customers, although that is stabilising. We are improving in acquisition and the number of the operating parameters are improving. But these factors, plus the factors we had in February this year which we announced in the middle of the year and warmer weather this year mean that we expect UK business to be broadly break-even.

Those are the two principle impacts that have resulted in our forecast of around 12.5 pence per share EPS. This is obviously subject to weather, commodity prices and operations for the remainder of the year.

The second thing is that we remain on track despite this to hit our 2017 targets which we set in February around adjusted operating cash flow of £2 billion, cost and head count targets and our efficiency programme is running ahead of plan and we are forecasting savings of approaching £300 million, on top of the £384 million we delivered last year. Our other targets are on track including capital expenditure and our net debt is forecast to be well within the £2.5 to £3 billion range which we set at the beginning of the year.

The third message is that our balance sheet has been materially strengthened as a result and phase one of the portfolio repositioning of the Company will be completed at the end of this year, including the £946 million of divestments against our £0.5 to £1 billion range. And we expect our credit metrics to be at or above our thresholds by the end of the year and Jeff will answer questions on that too.

Notwithstanding our disappointment, particularly in North America Business (NAB), there are encouraging signs of momentum and stability and I just want to outline a few of those. We have signalled that in the UK Home the outcome is likely to be broadly in line with 2016 and this is despite customer, headline customer losses of 823,000 since the middle of the year. But the majority of these losses relate to as we outlined, collective switch customers, books of those rolling off. And I am able to tell you that we no longer have any on the books. The white label fixed price customers rotating in the very intensely competitive fixed price market, and the loss of some prepayment tariff customers. Customer numbers are therefore down, but the core customer numbers trading between standard variable tariffs and our fixed product under British Gas, are down 150,000 and that is the competitive impact that we focus on and worry about the most.

Because of our cost efficiency programme we have offset the decline in gross margin so that UK Home results will be resilient versus last year and in fact as we have indicated therefore, I think slightly ahead of consensus. We are developing a number of new propositions and services for our customers which are being well received. And in the services area we have seen in recent weeks customer accounts stabilising. So UK Home encouraging progress.

In the Consumer Division as a whole, we have seen gross margins decline offset by cost efficiency. In Connected Home, we continue to see some significant growth rates around hubs and products. And as you know we announced the Eni partnership this month. In Distributed Energy & Power, site work continues and we continue to build capability and as you know, we have established a new joint venture, Spirit Energy in E&P and that will begin in December subject to regulatory approval.

So that is the fourth message. So notwithstanding the disappointment in NAB, there are currently signs of momentum in other parts of the Group and I won't go through all the other business units.

The fifth message from earlier this week is clearly, I am well aware that the political environment and uncertainty around the UK energy supply market has been an extremely difficult situation to assess and predict. We announced earlier this week a comprehensive package for the improvement of the UK energy market. The early indications that I have had from the Government are that this has been cautiously well received. We believe under any circumstances, whether it is a price cap or the scenario resulting from some of our interventions, we believe we can deliver attractive and sustainable business in UK energy supply whatever the outcome.

And finally a word on the dividend. We have provided two messages in the Trading Update today. The first one is that the 2017 full year dividend is underpinned both by cash flows and by our earnings. And the second, very importantly, is that for a period of time, as we transition the portfolio and until the UK market situation settles down, we are willing to operate with dividend cover below historic levels. And obviously recently in the last couple of years we have had dividend cover levels of about 1.4 in 2015 and 2016. This year clearly as you do the maths, we are looking at dividend cover of 1.04 and what we are assuming is that we will need to operate for a period of time with cover below the historic levels. We are confident in being able to manage the Group at those levels of cover while we transition the portfolio and implement the strategy.

I would now like to hand over to questions Natalie if that is okay. Thank you very much.

Questions and Answers

**Q1.	John Musk, Royal Bank of Canada**
Morning everyone. Really just a question to try and understand how things have deteriorated so significantly in the past couple of months since the half year results. I mean were there no warning signs or no visibility on this when we were all speaking back in July?

And then secondly, following up on the growth that you are indicating in the Connected Home market, are you going to be able to achieve your targets there around the product sales of £1.5 million for this year? And are you still confident in the longer term break even target for 2019?

Answer: Iain Conn
Thank you John. So let me start on the visibility point and the Connected Home point and then I will ask Jeff to expand on the North America business situation because I think it would be good if we could have one fulsome answer to that right up front.

So first of all John it was not fully visible to us in July at all. We had had a successful first half in North America Business and we were booking good net margins. But the guides were signally the competitive pressure, but we had not seen the low volatility over the coming months which has arisen and we had not seen the impact of the shape of the curve as we were continuing to sell margin in the power book. And clearly this resulted in the final review with our recent performance reviews. We have very intense performance reviews each quarter and our conclusion was as a result of that that this would materially impact 2017. We did see this in our third quarter review and we did see it in our fourth quarter review which completed last Friday. And we concluded not only would it impact 2017 materially, but obviously there will be some continuing impact on that given the shape of the curve going into 2018.

In the matter of the revenue recognition accounting issue which I will ask Jeff also to cover, we did not know about this until this last week and we have been intensely evaluating it to make sure that it is an open and shut case, that we understand when and where it arose, how it arose, why it arose and that it is completely bounded and contained. That is the case. Now I will let Jeff expand on both of those because I think it is important you understand where we are in NAB.

I should say that the other three books that we operate are operating to plan. In Connected Homes I am very encouraged by the results, specifically on your question, will we hit our targets? We have a very important month and a bit coming up. We are right in the middle of one of the heaviest trading weeks in the year and we have significant momentum which appears to be accelerating. I think it is likely that we will be very close to if not hitting the target for products for the year. We are over 1.2 million products, our target is 1.5 million, but we are selling a much higher rate here with products to hubs than we were in 2016. And I am very encouraged by progress here.

On the million hubs, it looks difficult for us to hit the million hubs from here, but we have got to 750,000 hubs so far to this point. And the growth rate versus the end of last year of 42% on hubs and 59% on products, are very material.

The second part of your question is are we confident still about our forward projections? We have absolutely no reason to change the £1 billion revenue by 2022 target and the important development of the ENI partnership tells us that we can go beyond our own customer channels and that there are third parties who want Hive and want to offer it to their customers on our terms, and it is very important, on our terms. But I remain very encouraged by Connected Home and yes we are on track for the long term targets.

I would now like to hand over to Jeff to go into more detail about the North America Business situation and including the revenue recognition points.

Further Answer: Jeff Bell
Thank you Iain. Maybe just to start with the one-off accounting charges. As Iain said it is a one off post tax, non cash impact of £46 million pre-tax as an operating profit level £76 million. And is an issue that as we have been consolidating our billing systems and doing our continued balance sheet and financial process improvement as we look to generally improve within North America overall, this issue has come up as Iain said, dates back to 2013 and is small differences in unbilled revenue estimates, that is a tiny proportion of revenue but has built up over the last few years. So clearly disappointing but we are confident that we have sight of that and it exists in just one of the billing systems that we have.

I think in terms of North America Business over all, clearly from a go forward prospective, to this year's results you would have to add that, the one-off accounting charge. We don't clearly see that going forward so that our projection of about £80 million this year within that charge would have been in the £150-160 million range.

I think John to your point, we were seeing, to Iain's earlier point about the four areas of pressure we have seen in North America Business, we did see and signalled at the half year that we were seeing unit margin pressures in North America. But in reality it is only since we have come into the autumn period and you don't see this as much in the summer because volumes are so low. But as we have come into that we have seen both the full extent of the competitive pressures, but again compounded by warm weather such that we haven't been able to start the winter season as we would normally with gas volumes and gas volatility. We do obviously consider that does happen from time to time, but we would not assume that would normally happen every year. Under normal weather we see a much more normalised flow of volatility and optimisation revenue around that. And the same would be with the backwardation of the curve. Clearly the unit margin pressures we expect to continue on into next year, but typically has a cyclicality to it within the industry overall.

Answer: Iain Conn
Thanks Jeff. The only other thing to say John is that other market participants have seen the same impact. Exelon as I understand it and Just Energy are also seeing similar particularly impacts of the forward curve. John thank you very much and next question please.

Q2. Sam Arie, UBS
Good morning, thank you for the Presentation and very helpful explanation just now of what you have announced this morning. I have just two questions and the first one is thinking about the earnings expectation for this year at 12.5p or 13.3 excluding the one-off charge. That looks to be about 2 pence below consensus and when we run some quick back of the envelope here, we roughly estimate that 1 pence out of that is probably further one-off effects as you have described and the other half would be recurring. And I just wanted to check whether that makes sense to you as a sort of high level summary? In other words, excluding the North America one-off accounting charge, is about half of the rest of the mix non recurring and half recurring?

And then secondly, on operating cash flow, well obviously it is very positive that you are still expecting over £2 billion this year. Can you just tell us where that leaves us in terms of your target of adjusted operating cash flow growth of 3-5%? I think last time we were speaking there was speculation that the SCRIP element of the dividend might be neutralised in the future. Does that still seem like it would be viable? I think the SCRIP take-up was about 40% this year. Or is that now something that looks more difficult with the earnings coming in a bit lower than expected? Thank you.

Answer: Iain Conn
Thanks Sam. First of all, there are a number of other parts to the Portfolio that are performing well as we have just indicated. And obviously we have got other things that will not be recurring next year that have impacted us this year such as the exploration and production outage at Morecambe for 9 months in order to improve the asset integrity and safety. So there are lots of moving parts in the Portfolio. But I think broadly your assertion of about half, other than the accounting impact from the revenue recognition item, about half non recurring and half recurring would be about right would be my judgement.

And as far as the forward projections of the Company are concerned, I recognise that this is a very difficult time for people to judge Centrica in the context of the uncertainty, particularly the political uncertainty that is going on around us. But no part of our financial framework is currently changed and we don't intend to change the financial framework. The judgement we have to make about the cash flow growth is, it is a medium term target and the judgement is when will we see enough of it and be able to see it through all of the political uncertainty and interventions potentially so that we can be confident in it. We have no reason to change our view of what this Company is capable of and we have just gone through an annual planning process with our Board where we have been looking ahead for the next five years and it remains the medium term target.

And it is also true that our dividend philosophy in the financial framework is also unchanged, but we have to recognise that we, given the uncertainties of a potential price cap and/or other interventions in the market in the UK and despite our view of how we can drive efficiency, and there will be further efficiency announcements that we will be updating you on in February. Despite that, we currently recognise we will have to operate potentially with a dividend cover that is below recent years and we are willing to and able to do that.

Thank you very much Sam, can we move on please.

Q3. Dominic Nash, Macquarie
Hi good morning. Two questions please. A quick one on 823,000 customer losses does appear quite a high number, but you say 650,000 of those are from sort of blocked rates. How many other blocks are there in your book that we should be aware of that could be coming out in the coming months?

And secondly do you have a view for what the consensus going forward in the North America Business is in the financial community and do you think following up from Sam's question, what we see this year on an underlying basis is more representative of that business going forward?

Answer: Iain Conn
Okay. Well let me start and then I will pass onto Jeff on the North America Business. But in terms of customer numbers, clearly 823,000 is a very large number, but as we indicated at the middle of the year, we are very much customer segmenting this and looking at the standard variable tariff base which obviously we are now going to be encouraged to move to other fixed term products. And indeed we are seeing successfully our interventions moving customers from the standard variable tariff to the fixed term contracts without losing the customer. And we have seen therefore net-net with standard variable tariff customer losses and people moving onto fixed products, this 150,000 customer impact. So in terms of the really high value customer base, we are still seeing relative stability.

Now on your specific question of books, customer books that roll-off where we have actually acquired customers in a block, as I indicated earlier we have no more on the books in the UK at all. So you will not be seeing that and we have seen some very significant movement in that area. So there are no more in that regard.

And as far as North America Business is concerned, I mean clearly you have to add back the one-off impact to the £80 million. But let me pass on to Jeff to talk about expectations from that business going forward.

Answer: Jeff Bell
Yeah I think Dominic, as we were saying earlier, if we add back £150-160 million, you know if I took as an example the comparison to last year where the business made about £220 million, I think the differences we have seen, you know partly that difference is related to you know unit gross margin pressures, particularly in power. Iain talked about merchant generation. We wouldn't, until we see that easing up, that looks like it is a part of the market structure at least in the short to medium term. On the other hand we are seeing things like much warmer than normal weather to start the fourth quarter in North America, which has impacted volatility, impacted our ability to optimise, impacted the supply margins themselves just through lower volume. And this issue of higher front part of the curve and input cost for the power book because of the backwardation in capacity markets. So we would see that difference, half to two-thirds being unit margin pressures. The other third or so is probably more phasing just in this year because of the way weather impact on the business has been.

Q4. Mark Freshney, Credit Suisse
Morning. Can I ask two questions please. Firstly on Connected Homes. It seems that you have a lot more Hives out there, but I think one of your retail outlets, Amazon is very heavily discounting that right now. And I know that once you cut the price of something in the UK it is very, very difficult to put the price up. So I was just wondering as to what the gross margin contributions from those incremental sales is looking like

Secondly, Distributed Energy and Power, it seems that that business is performing well. Neas won a very, very large contract. Can you talk more, I don't think you specifically mentioned profitability there. But that seems a business that is well on track to reaching that billion revenue aspiration by 2022?

Answer: Iain Conn
Thank you very much Mark. First thing, on the first one, we are right in the middle of the Black Friday week. It is one of the traditional weeks where lots of products are discounted. That is why you are seeing discounting this week. I can assure you that gross margin and holding onto the right levels of gross margin as we grow Connected Home is our guiding light. Which means that we will not just chase volume for the sake of volume, and that is very important. But we are seeing attractive gross margins and we have ensured that in the Eni partnership which we really haven't spent much time talking about, where we are looking at the access to eight million customers in Italy. And those customers will experience Hive, they will experience the Hive brand and it will be our relationship with the customer and our customer data which we will then share with Eni. And we have a schedule of measures in there where we will obviously share some of the gross, more of the gross margin up front at the very early phase, but the unit margins are extremely attractive. And that is also true with all the manifestations of Hive that we are selling today. So I am very encouraged by that.

And you mentioned Amazon. The relationship with Amazon is very good. I have had a long meeting with the senior guys at Amazon talking about how Echo sells Hive and Hive sells Echo and whether we need to think about how we go to market together. So I would say that Connected Homes is a difficult business to be absolutely certain about precise deliverables in any short period of time. But the acceleration is very encouraging.

On Distributed Energy and Power, I just want to correct one thing, that it doesn't change your conclusion. But Neas Energy is actually reported as part of our Energy Marketing and Trading Unit. You are right, Neas is doing very well. In fact I am pleased to say that all of the acquisitions we have made so far are doing really well. Neas and EM&T and there are some capabilities which I think is what you are alluding to from Neas that are helping us in Distributed Energy and Power. We also have seen very good results from ENER-G Cogen and as you saw very recently, we have just purchased REstore, the leading European aggregator business. And when you build all of these into the Distributed Energy and Power business, under the brand that we are now going to market with, which is Centrica Business Solutions, we now have a complete set of capabilities which we are now integrating into a platform. You saw some of that in the Capital Markets Day which we believe will mean we can offer things to business customers that other people cannot. But we are also on track for the £1 billion revenue target for that business in 2022.

Q5. Lakis Athanasiou, Agency Partners
Hi guys, two questions please. One is any read across on competitive pressures particularly in regard to activity by generators moving downstream into residential markets?

Secondly, do you think you should be now considering improving your reporting on North America? A few years back you did combine your heavily loss making services into residential supply so we lost visibility there. You stopped reporting on regional customer numbers. And I think now there is a need to split out reporting between supply and brokerage optimisation, so any comments on that please?

Answer: Iain Conn
So we are not seeing power players currently moving into the residential market in any of our geographies. I think we have got to be very awake to competitive pressures but that is not something we are seeing. And I think generally speaking from talking to people in the market, I think power players really don't know how to deal with residential consumers. I think the way you get the battle ground is in the wholesale markets and into access into large industrial commercial customers where you are clearly seeing large power players in North America in particular, looking at that. And you are also seeing some of the large traders like Gazprom and Total and others using those industrial books to trade around and complete their supply chain and their risk management. So no we are not seeing that.

On your point about disclosures in North America, given the impact that we have just reported today, we need to take that onboard and I think that your point is totally valid. We have been trying to balance a lot of disclosure in a lot of business units with, there is a never ending demand for more detail, but given what has happened we will take that onboard and we will report back to everyone in February.

Q6. Martin Brough, Deutsche Bank
It is following really from Lakis' comment. Given that you have highlighted that there are IPPs now in the US that are looking to access the route to market directly downstream to customers whether they be residential or business customers. Do you think that there is a case for looking at exits of retail in North America if there is more strategic value to some of the other players in the market that have upstream generation that perceive a route to market value? Do you really need the full scale of the retail business that you have got in North America? If somebody came along to you and made you an offer would you consider that?

Answer: Iain Conn
I believe that our business in North America is core. The capabilities that we have are exceptionally good in my view in North America business. I regret deeply the performance that we have delivered in the last part of this year, but that is not a rateable business without risk. We clearly operate to serve very large numbers of customers with very sophisticated products against a backdrop that is complex and can be volatile.

I can absolutely assure everyone on the call that we did not expect this scale of impact this year. And there are questions that we have got to ask about the product suite that we are offering, whether we are sharing risk adequately between us and the customer. We and other market participants faced with this phenomenon in the second half of the year have been starting to change the product. The market has been operating with a pretty standard period, i.e. about 3 year fixed price deals where the supplier takes the risk of a number of markets and regulatory instruments as well. And we need to review whether we are prepared to take that share of the risk exposure relative to the customer. It has served us very well up until now. And this business, although it has had a couple of very volatile periods, one just before I arrived, part of the vortex which everyone remembers, and this situation this year. But this business delivers very high returns and we have unique capabilities and market positioning relative to our competition. So I believe it is absolutely core, but clearly we do not want to be delivering this type of result with any frequency at all and ideally never again. But it is a very core business to us.

Martin Brough
Okay, thanks.

Q7. Chris Laybutt, JP Morgan
Good morning. Just two questions. The first, on the US business there has been quite a lot of M&A activity in the US and I think your business would be very attractive in that market from an M&A perspective. Would you consider selling it as a way to lower the volatility of your earnings? And perhaps that may not hamper your aspirations to grow Connected Home if you could sort of sign agreements with the new owners to partner up on the Connected Home front.

And secondly, just in terms of the 650,000 customers in that block, could you give us an idea of how many were in the block, how many were pre-payment and how many fixed?

Answer: Iain Conn
So first of all, Chris could you clarify, the previous question from Martin obviously was about selling our North America Business and I answered about North America Business, i.e. NAB, is your question referring to the Home Business or are you asking the same question?

Further question clarification: Chris Laybutt
My apologies if I am, I was doing two things at once, but in terms of partnering specifically would that hamper your ambitions to partner?

Answer: Iain Conn
So first of all, our strategy is to have a portfolio of businesses that are taken as a whole, resilient. And we believe that exposure to different geography and different customers is very important as we believe we need to balance and rebalance the exposure from commodity energy exposure to other services and propositions. We believe that that will result in a stable and resilient portfolio overall, but recognising in energy supply there will be regional differences and volatility. We will consider partnering clearly and one of the options as the Italy contracts demonstrates, is to expand some aspects of our Connected Home business and other services we offer through other partners. We do not need to be doing it through our own energy customer relationships. And that does not immediately say what we should do is get out of energy and try and replace it with pure services. We see it very much as a balance. Does that answer your question Chris?

Further question: Chris Laybutt
It does, thank you. And on the 650,000 customers?

Answer: Iain Bell
Yeah, so we are not giving a split. What we will do in February is give the look back bridge of customer account changes just as we did in the middle of 2017, showing the categories that we are either de-emphasising or are ones where in the highly competitive market people have rolled off. As I said to an earlier question, we don't have any more of these large books, but I can tell you that approaching half of that number roughly was the collective switch book roll-off.

Further question: Chris Laybutt
If I could just ask one follow-on which is on that theme. Some of your competitors, particularly energy have started to focus on keeping their customer numbers flat. You have appeared to start to focus on margin, is that a deliberate ploy or is that just a nature of your pricing in this period? Can you give us some colour around that please?

Answer: Iain Conn
Well I think we indicated, well we have done a number of times, that we want to focus on customer segmentation and giving those customer segments what they value and need. And that does not mean a pursuit of numbers as a driver. It means drivers as an outcome. And we have seen as we have analysed the UK market more intensely over the last couple of years. We realise some of the activity in the market not only appears to be, but is sub-economic. And so acquiring customers at really aggressive levels, unless you are going to flip them onto a really high standard variable tariff when they are not looking which is a practice that we have decided we do not support. Unless you do that and it is quite unsustainable we believe, especially in the face of a Government price cap intervention potentially. We believe that is sub-economic and what we are not prepared to do is acquire customers who we believe within a reasonable period of time we are unable to cross-sell or up-sell to create NPV. And some of our customer segments if we were to pursue them for the basis of customer numbers they would be value destructive quite significantly. And so we don't think that is what any of you would want us to do. It is not what we want to spend our time doing. I can't comment about some of our other competitors, but I do believe there is a degree of papering over the cracks to some degree if you pursue that and it is quite a distraction.

Chris Laybutt
Okay, thank you very much.

Q8. Jenny Ping, Citigroup
Hi thank you, morning gentlemen. I just want to if I may, pin you down a bit on your reference on your willingness to operate the dividend cover for a period of time. Can you talk a little bit more about your thoughts on the definition period of time of those Connected Home growth related? Is it looking at the SVT cap impact? Just a bit more colour on that, that would be great.

And then second question, on the block of customers, you said there weren't any more in the UK. Can you disclose what the blocks are in the US?

And then just thirdly, in terms of the impact on the SVT cap, presumably in your five year plan that you mentioned earlier you have had some working through as to what the potential impact would be if the SVT cap follow a similar methodology to the PPM cap. Can you comment a little bit on that as well? Thanks.

Answer: Iain Conn
Well Jenny, great questions. Difficult ones to answer with full disclosure today. But let me go through them one by one.

So first of all on the dividend, we are clear how important the dividend is to our owners. We are also clear that that dividend is very important to our owners at the time when we are having to shift our own portfolio and at a time when the market is also changing dramatically. We therefore are signalling that there is a period of time that we recognise contains uncertainty. Uncertainty about our ability to net grow. We are seeing some pretty important green shoots. We are focusing quite a lot on stabilising services with the intent to grow services. And you have seen how services has been very stable, but it has not yet been able to grow. We are getting quite excited about that. The Connected Home growth, the proposition development and customer segmentation in energy supply which we have just been talking about. All of these things are capabilities and route to market changes that are required which we are developing and making significant progress in. But that will take a bit of time.

We also have got a, we have shrunk the balance sheet of the company significantly. And the question is, can we start to re-expand it, not necessarily dramatically, but we clearly need to look at options which would allow us to deepen in the areas where gross margins are high and where we have the requisite skills to compete.

And then the third component you mentioned is clearly the political backdrop around the UK energy market. I hope we have demonstrated by the Trading Update that we are able to offset gross margin decline despite these dramatic headline reductions in customer numbers with cost efficiency and the new propositions to the customer segments we are targeting. What this all means is that we believe we will have an attractive and sustainable business in the UK energy supply however the end game of the marketplace over the next if I take the time frame governments talked about, two to three years as they talk about a price cap, if it is going to come into being, being in place at the end of 2018 or early 2019. There is quite a lot of uncertainty that we have to steer Centrica through, but signalling that over a period of time we are prepared to operate with dividend cover from earnings below historical levels. And clearly the only way you would do that is if you are confident about a subsequent period where dividend cover returns to more healthy levels. And that is what we are signalling.

In terms and I should say we will obviously give a bigger update, a more extensive update on that and our dividend policy in February.

In terms of blocks of customers in the United States, I don't have the data on that today. Let me just ask Jeff if he does, I don't think it is particularly significant?

Jeff Bell
No I don't have that today Iain. Like the UK and to a smaller extent we have historically been involved from time to time with aggregation and collective switch type deals in the US. But as we, also in the US like the UK, been much more focused in the businesses around value customers, you know. We have largely pulled back from the US in that as well. So that has become and will be a fairly small part of the business over there.

Further answer: Iain Conn
And on your last question Jenny, the standard variable tariff cap if there is one and I don't know if there is going to be one. But even if there is one, the announcements we have made this week on proposals for the UK energy market we believe are good for all seasons. Of course we have tried to model scenarios in our planning. It is quite difficult to do and therefore, because it is quite uncertain. But what we have been able to do is model our own response capability and model the types of scenarios that we envisage given the Government's guidance so far because the Government has been very clear that a cap needs to be set at a level which still encourages investment, but drives efficiency and drives competition, but doesn't remove competition. And still allows programmes like the smart meter programme to continue. Now that is a pretty complicated formula.

But if you analyse that, where we start with our standard variable tariff, below 85% of the market, and the fact that the Government is signalling that they are not intending to make the market completely fail, we believe we can model a range of scenarios around that. And when coupled with our own interventions, both in terms of the customer segments we are targeting and the propositions we now have, the systems and processes we now have in place and the efficiency programme which we are pursuing, we are confident we can give the guidance we have given today and on Monday really whatever the outcome. You know you can never say never, but we believe we can create a very sustainable and attractive business whatever the final outcome is. I have spoken to the Government about our plans and proposals and have received cautious, warm reception about a step in the right direction. And I think we are going to be able to initiate more constructive dialogue now with the Government. These proposals have been seen as comprehensive and very thorough and I think they have given the Government serious cause for thought about how many of these they should incorporate. Thank you Jenny

Jenny Ping
Thank you.

Q9. Ajay Patel, Goldman Sachs
Good morning, I just have three questions, but relatively short. The first thing is looking at the business as a whole, North America and UK. And I know that some of the impact today is weather related. But just thinking about margin pressure going forward, what makes you confident that this isn't the beginning of just increased competition reducing margins and that we are not rebounding on to a maybe slightly reduced margin level, but actually you just have a structural theme of those margins getting more and more compressed as the competition increases?

The second question was on the dividend comment about a period of time. Clearly you are a company in a lot of change and there is a lot of work being done on the growth businesses and changing the business model and the proposition. When do you think, when you talk about a period, when do you think that transformation is complete? Would it be when the growth businesses break even or would it be when you begin to actually see a view to attaining the revenue and potentially the profit targets that come from the growth division? I am just trying to get a feel for that.

And lastly on the customer side where you have talked about the 650 block trade. It kind of gives, well it is clearly that they are lower margin customers that you have lost so it is not as negative on profit as you would expect, but it does kind of tell us there is these amounts of profit dispersion as in your profit margin on your costs to your customer base is very different. And just looking at the gas customer base where there is a 15% EBIT margin, how much could that dispersion be? Are you making somewhere between a 20 and 10% EBIT margin or is it wider? Is there any sort of feel for this because I am just thinking if the pressure is on default tariffs and they may be some of your higher profit margin customers, is there a stronger downside on that than maybe you can see from the headline average number?

Answer: Iain Conn
Thanks Ajay. So firstly on margin compression. I have been in commodity energy businesses for 32 years. There is always a need to be agile and be highly capable in managing commodity risk and there is always a trend towards commoditisation, albeit there are limits to that commoditisation and there always remains risks associated with managing commodity market exposure which clearly mean that commoditisation cannot go to the ultimate extreme where there is zero margin even though some people talk about Blockchain eventually removing the margin altogether, which I don't fully subscribe to. But I would accept that there is a tendency towards commoditisation in commodity energy markets so the clue is in the name.

And I think therefore, very strongly, that a lot of it is about capability and offering customers things that they are willing to pay for. To do that you have got to be expert at managing risk. You have got to be expert at managing and providing risk services. You have got to be able to use scale in aggregation to allow you to optimise and create a return. And on top of that you have got to offer non commodity services around the commodity. And I think those trends are absolutely happening and that is what our strategy is based upon. We are driving towards two things. One the distributed nature of the energy system increasingly becoming apparent. And the second thing is that people don't just want energy, they want more than just energy. So it is a very important observation, but I would also say that the theory of pure commoditisation of energy markets has been around for 50 years or so and they are still alive and well. But we need to be experts in our capability if we are going to play.

When is the transformation going to be complete? I don't think there is a magic date, but we are clearly going to need to get to a place where we have the portfolio we want to have. We have done a lot of that, most of it in terms of the asset businesses. We have not yet completed the build out of the customer facing skills and capabilities we need in the five pillars of each consumer business we have outlined earlier this year. I am not prepared to give a date, but clearly a very important indicator will be when we can demonstrate sustainable gross margin and net cash flow growth and deliver attractive returns. And those are the objectives we have set out and we should be able to see that within the next few years. But I am not prepared to tie it down to a particular date.

On customer margins, yes there is a discretion of margins and I just want to be clear, some of these books that are rolled off are worth zero NPV so they have no impact on the Company's financials. In terms of EBIT margins, everyone quotes our high EBIT margin on gas. I just want to remind everybody that our absolute gas price within the bill is highly competitive despite us having high EBIT margins. So we do have a dispersion of margins. We don't expect them all to be the same. We are more aggressive on electricity than we are on gas. We are trying to rebalance that a bit as you saw earlier this year, but not particularly worried about that. And there will be a dispersion of margins always.

Q10. Nick Ashworth, Morgan Stanley
Hi morning everybody. Two questions from me. Firstly just on the dividend just for clarity. So are we talking about 12p dividend for this full year? And then is the assumption that that will remain flat over the next few years given the headwinds and uncertainty we are talking about? So I just want some clarity around why you are actually staying on the dividend level over the next couple of years?

And then secondly, thinking about Connected Home, you have obviously talked a lot about the green shoots and the positive growth that we are seeing in that business, how do you think about that growth and how aggressive you want to be in that business given all the uncertainties elsewhere? Because it feels like with North America today, that adds onto the political uncertainty in the UK. Does that make you any less keen to be more aggressive on Connected Home growth? Does it make you keener to get these products out faster? Or does it not change? I just want to get a sense of how you feel about these growth businesses given it feels like the uncertainties in the core businesses are sort of mounting up.

Answer: Iain Conn
Well thanks Nick. I mean I know there have been lots of different ways of asking the same question around the dividend. I mean we have been clear that the full year dividend at the current level is underpinned. So you can assume that a 12p dividend for this year is underpinned. We are not giving guidance about the absolute level of dividend going forward. What we are saying is we are prepared to operate with a level of dividend cover from earnings that is lower. You will need to draw your own inferences from that. But clearly we are prepared to operate with the dividend slightly less covered than it has been. And that is the thing you should draw from this and it is a signal of confidence that we can steer Centrica through a period of difficulty, no

question about it, and uncertainty associated with particularly the evolution of the energy market in the UK, without our investors becoming concerned.

In terms of the Connected Homes growth, this situation does not make me keener, I remain very keen to grow Connected Home. I was out with customers yesterday morning, I was sitting in someone's living room talking about Connected Products and they were saying it would be really good if we could get our connected products and energy. They didn't know who I was by the way. And I was saying well some companies are able to do that, would that be interesting to you? And they said, absolutely. So we were talking about that. Another customer was talking about monitoring of an elderly relative in their home who needs constant care. And I am absolutely sure that the connected spaces that we have chosen to direct our attention at, peace of mind, home energy management and home automation, are growing areas of real interest to customers. And if you can combine them with energy or sell them on their own, it is giving customers what they absolutely want and need.

And I am very encouraged that other companies are now seeing our positioning in the Connected Home as sufficiently attractive to ask us if we would exclusively given them access to it, such as we have had with ENI. So I am very keen to grown Connected Home. We are very conscious however that the s-curve should not be so deep that the company can't afford it. We believe we can manage that and we can come out the other side of that s-curve with some quite attractive, very effective gross margins and attractive growth rates.

Nick Ashworth
Thank you very much.

Q11. Fraser McLaren, Bank of America, Merrill Lynch
Good morning. Just a few questions please. First of all on UK business supply. This has been a difficult division for a long time. How confident are you that you will be able to get a grip of it?

And secondly, I hear your message about cash and debt still being within the range, but there is clearly less headroom now, together with the potential impact from UK supply intervention. I am wondering about the extent to which this reduces your flexibility for acquisitions and indeed growth in your chosen areas of development?

And then just finally, does lower cover for a while include a number less than one? Given that the last scenario was where UK supply caps could nudge earnings materially lower while growth kicks in elsewhere? Thank you.

Iain Conn
Jeff do you want to talk about UK business. I will come back on the other two?

Answer: Jeff Bell
Yeah so Fraser to your question. You know yes we are seeing continued competitive pressures in the B2B business here in the UK. You know pressures from large sort of large suppliers you know like the likes of oil and gas majors etc coming more and more into C&I space. And it being a highly brokered business and pressure from brokers currently. So we are experiencing that here of late as the business continues to drive costs out however. We do expect and do believe the business will grow from here and that those margins will return. Our full year results have been held back a bit by issues from earlier in the first quarter this year. So we would expect it to grow going forward. Clearly it won't return to the profitability levels we had a number of years ago when of course the business model was quite different and there was the whole auto-rollover

segment of the market. But it has taken a bit longer than we had anticipated here in the second half.

Answer: Iain Conn
Fraser on the other two questions. So cash and debt levels cover acquisitions. We will always only do acquisitions if they are core to the strategy and are attractive for the shareholder and economically attractive in the near term as well as MPV accretive over time.

We have flexibility with in our financial framework and as we have been demonstrating to do small acquisitions that would build capability. We do not feel prohibited from looking at acquisitions at this time, even with this performance. But clearly I recognise that the bar obviously is high at the moment for doing any acquisitions other than small infill acquisitions. That shouldn't stop us looking for them if we believe that they would be potentially important for our strategy. But I want to emphasise performance comes first and that is our focus and we are not going to be distracted by the pursuit of 'get out of jail free cards' if that is the type of acquisition that people have in mind, because that is not what we do. But we are prepared to do and demonstrating a track record in doing, acquisitions that build out our capability for the longer run.

On your version of the question about dividends, lower cover for a while in theory obviously includes lower numbers than one, but I want to be clear that I don't want to be running a company where it has dividend cover from earnings that is below one. There are circumstances in a commodity exposed company when you get kicked into that territory, but I can assure you that we have no plans to deliver for any period of time, dividend cover that is unsustainable like that. And our job is to operate so that we get to more sustainable dividend cover levels and I am confident we can do that and I don't think dividend cover from earnings should be the only metric that you look at a company through. There are plenty of companies that operate for periods of time with dividend cover below one. It is entirely possible to do so. It is not something that I want to plan to do. And I don't think we need to at this stage.

Q12. Mark Freshney, Credit Suisse
Hi, just a question again on the balance sheet. I know I ask you this every time I see you and I will ask you it again. You know, you have got gross debt of £6 billion. The market value of that debt is some way above £7 billion to buyout. You are only using about £2.5 billion and I guess that could well go down even next year with things like the SCRIP. Clearly it is a very big drag on earnings. I know you keep it constantly under review, but is it possible you can do anything to right size the balance sheet, or if your thoughts have changed since I last asked you the question in September?

Answer: Jeff Bell
Hello Mark, it's Jeff. I am going to give you the same answer I did in September, conscious that that may not be as fully satisfying as you might like. You know, listen, very conscious as you would imagine on the difference between gross debt and net debt. And we are looking at ways in which we might be able to manage that as efficiently and as effectively as possible. And we not only keep that under review, but we actively look at opportunities to make that more efficient. And when we see the chance to do that then obviously we would announce that.

Mark Freshney
Okay, thank you.

Q Andrew Moulder, CreditSights
No connection.

Q13. Ingo Becker
Thank you good morning. I had a question on your UK Home business. Hopefully you did not answer that already. Can you give us an idea about the impact of the customer losses that you are experiencing? Apparently you had not absolutely favourable weather, you are losing quite a lot of customers but you are still expecting this business to be slight. Is it possible to give some kind of breakdown on how efficiency gains, how the different customer value segments that you have been categorising are playing to here? Where you are losing what and where you might just not lose that much and what the related costs are?

And a related question might be, pre any cap on the SVT or otherwise next year, which I guess we all have to work out for ourself, if the market would just continue as it did lately would your experience on customer losses and what you can do against that, assuming normalised weather, just conceptionally so I am not talking you into giving us guidance at this stage. But conceptionally so pre a cap given normal weather would you think this loss assuming you can defend that around about £800 million profit figure over say the next 12 months at UK Home or are those impacts, first part of my question suggesting somewhat different outcome? Thank you.

Answer: Iain Conn
So we are going to give you guidance on the Company for 2018 in February. And therefore not prepared to give you specific steers on individual business units at this time. However, let me just recap. I mean what is going on in the UK Home is that the market is highly competitive and we are seeing customer segmentation become more and more extreme where you have got some customers that continuously shop around and they are only interested in price, only interested in the cheapest price and they don’t care where they get it from. Those customers are very unlikely to generate material value when you acquire them. And they are very unlikely to want to buy any other goods or services from the Company. They are just interested in energy, only energy, the cheapest energy and they don’t care who it is from. Those customers are extremely unlikely to be attractive to us. There are however plenty of other customers who do care who they get it from. They do want other goods and services. Some of them actually do want the standard variable tariff which is going to be a challenge for us as we try and persuade them to come off it, because they just want someone to manage the product through time.

And therefore we are being much more focused on individual customer segments and we are offering reward programmes for loyalty. We are offering a boiler servicing and energy. We are offering Connected Home and energy which by the way these are sources of gross margin. Our competitors are unable to offer. And so we are starting to see the stabilisation of our gross margin. That is really important and we expect to be able to stabilise it and grow it on a unit basis.

Now the question is, can you ultimately stop the customer losses as well, because there are proportions of the customer, the higher value customers who decide that they are just going to become a price oriented customer and we are seeing a roll-off of some of those, not at as high a rate as the headline numbers would suggest. That means we have got to drive efficiency in order to deliver net margins over the period until our customer base settles down. We are confident we can do that. We have demonstrated we can do that. Clearly a very large proportion of the approaching £300 million of efficiencies that we have indicated today is in UK Home. And as the world goes more online and more digital we are going to pursue those trends which are obviously going to result in bringing our cost base down as well.

So we are confident, it is a core part of our strategy, of creating a sustainable and attractive business in UK Home. But that is as far as I can go.

Okay, I think we are nearing the end of time. We will take a couple more questions and then I think we should call it a day.

Q14. Deepa Venkateswaran, Bernstein

Thank you, this is Deepa Ventakateswaran from Bernstein. I had three questions. So firstly your UK Home performance for the year is maybe better than where we were expecting it. Could you just say how much of this was cost cutting or you know what is the source of that? Is it services, is it energy, is it cost cutting?

Second question, Iain you were mentioning that you have done some work on different scenarios on where the price cap needs to come in if it needs to meet all those different objectives laid out in the draft bill. How far do you think it could be from where say the premium and cap which is also applicable now to the vulnerable customers, that is roughly at £1,030 per customer for this average consumption. So how far do you think the cap needs to be about that to satisfy all those conditions?

And my last question is a clarification. I know Jeff in two previous calls you have talked about it, but what do you think could be an underlying level of profitability for both the North America Business and the UK Business combined going forward, given that you know this year effectively adjusting for the one-off it is £126 million or so for those. So any view on where your current thinking is on a steady level of profitability for the two business units combined? Thank you.

Answer: Iain Conn

Well look in the UK, the performance has been good. I am not prepared today Deepa to give you any breakdown of performance, but we will be able to do so more in February. I am very encouraged by the way the organisation is adapting to a more and more competitive market. There is clearly a significant amount of cost efficiency as we have indicated, but in the consumer division cost efficiency has resulted in us being able to offset gross margin degradation to deliver a stable result year-on-year.

In terms of the price cap level for standard variable tariffs which I think is your question. There are lots of ways, there has been lots of speculation about this. If we get a price cap, the methodology to calculate it I am afraid has been thrown at Ofgem and the variables that they have to deal with are huge. And it is really complex and my assertion would be that they are going to have a real job trying to do it if the Government go ahead with it. The Government keep talking about this £1.4 billion detriment which we completely refute. But however if you did take that number, and I don't agree with it at all, and you divide it by 17 million households, you would get about £80 per household. The assertion is that people are being overcharged. We do agree that the market could be made more efficient and therefore there is definitely some tens of pounds per customer efficiency improvement, but we don't think it is automatically £80. But clearly if there is some proportion of that £80 that should result in efficiency, the average standard variable tariff is about £1,140 and you could imagine the scenario where the changes, whatever they are, result in £40-50 coming out of the standard variable tariff. That would mean it would actually end up exactly where our standard tariff is today.

And so at that level we would not see significant impact today. Obviously prices can move up and down depending on what happens from here. But it is difficult to really calculate where the Government would rationally put a price cap if they did or Ofgem were asked to. But I don't think it is going to be at levels that will stop us making a healthy gross margin. And when you add the cost efficiency, I think it is quite probably that we will continue to be able to make a healthy net margin as well which is what we intend to do and that is why we are making the statement we are today and indeed on Monday.

Jeff, would you cover the, how should people think about the underlying level of profitability in the Business Division energy units from here?

Answer: Jeff Bell
Yeah, I mean fair question Deepa. I think I have given a fairly extensive answer on North American Business which I won't repeat. I think on UK Business, obviously it is a business that we made £50 million in 2016. You know we did have one-off issues earlier in the first have in UKB. We are seeing more competitive pressure currently. But that is a level that we would expect to return to in that business and then ultimately grow from there. The business has lost some additional customers in the second half, but now that the operational issues are behind that business, it has been very focused on new customer products, online only products recently that is very competitively priced. And has a load of costs to serve that goes with that. So we do see the business being able to return to those levels of underlying profitability and you know grow with momentum from there would clearly be the target.

So obviously you know within the rest of the Business division is the Energy Marketing and Trading business. As we said at the half year, we continue to be of the view that phasing of profit will be heavily weighted towards the first half of the year, primarily due to the phasing of the historical long-term gas supply contracts that are in that business that do phase between periods and including within a year. And we would and do expect to come back with more visibility on the impact of those versus the underlying growth n the Marketing and Trading business, including you know areas like the Neas business which has been continuing to perform very well and give a bit more clarity on that in February.

Further question: Deepa Venkateswaran
You are saying that maybe around £50 million for the UK Business and I think earlier you said around £150 million for North America Business would be a general underlying expectation?

Answer: Jeff Bell
I think, clearly what I said is that we would expect to get back to 2016 levels you know in UKB that is clearly the target. And then you know ideally have continue to grow from there. In terms of North American Business, I made the observation earlier, just to reiterate it, we have said around £80 million this year, if you add back the one-off you get £155 million and then I made some comments about how much of the difference of that between that number and last year's number of £220 million, we see as related to weather and phasing and a bit of backwardation versus the unit margin pressures which may take longer to sort themselves out in the power business in the US.

Iain Conn
Thanks Deepa. And one last question please.

Q15.   Andrew Moulder, CreditSights
Yeah great thank you. Sorry I got cut off earlier, I just really had one question and I just wanted to know about how you see your credit metrics evolving over the next couple of years? It just strikes me this talk about low dividend cover potentially going below one. You have already done most of your divestment programme so there is not much more

to come from there. And it just strikes me that with all the pressure we are seeing you are going to have worse credit metrics for the next couple of years at least until this transition is done. And I just wonder if you agree with that and whether you see that pressuring your ratings?

Answer: Iain Conn
So let me start with just reiterating what I said about the dividend. I did not say that we are targeting or expecting a dividend cover below one. I simply said that if you are operating at a lower level of dividend cover which we are signalling we are prepared to do for a period, you clearly in a commodity exposed business could end up in a situation theoretically where you get below one for a very brief period of time. And lots of companies operate that way. I do not intend that Centrica operates that way. We need to plan for dividend cover which is obviously above one. And we need to plan that if we are operating under dividend cover that is below historic levels that it is not permanent and we can see our ways to restoring healthy dividend cover. And that is what we are signalling today.

Jeff, on metrics?

Answer: Jeff Bell
Yes so you know as we said at the half year, we remain confident and on track to achieve the rating metrics, the financial metrics that the rating agencies have set us and expect to be at or above those come the end of the year. And with the strong cash flow generation in the underlying businesses, notwithstanding Iain's point about you know where that is in the future, you know we expect to continue to be above those rating metrics going forward as well. Having the financial metrics that underpin the element of our financial framework of you know of strong investment grade credit rating we see as very consistent with you know where the business will continue to perform in the future. And as always, we have a lot of flexibility in the investment we are able to deploy into the business on a year by year basis. So I continue to see us being, having financial metrics consistent with our target ratings.

Iain Conn

Closing Remarks
Thank you Andrew. Well everyone, thank you very much for joining us. I just want to say one thing at the end. I am deeply disappointed with our performance in the second half. And obviously therefore I am deeply disappointed that performance, particularly in North America Business. We didn't expect this dramatic shift in the outcome at the middle of the year. We were seeing competitive intensity on power margins, but we did not expect the magnitude of impact. Although we booked healthy net margin in the second half of the year, quite a lot of it will appear in our P&L in 2019 not 2017. And therefore we are reviewing the products that we are offering and I really regret for our investors and those who follow us, having to provide news like this today.

Having said that, I don't want you to believe therefore that the whole Portfolio is unreliable and I think through the questioning I think we have talked about the rest of the Portfolio and how it is performing.

I also do not believe that this year's outcome in North America Business is the long-term outcome and I reiterate what I said earlier, it is an attractive business and we have got very highly skilled people. The issue that we are wrestling with is during 2018 unless the curve shifts, we are going to see this type of pressure on the P&L. And as Jeff said therefore, I think it is a reasonable expectation that adding back the one-off item and possibly seeing some recovery, but not back to historical levels in 2018 is the right place to be positioning this business.

We are absolutely focused on driving performance and I regret what has happened simply because the performance everywhere else outside of these two business units is actually encouraging. And I would just like you to know that we will leave no stone unturned to drive performance such that you will see the outcomes that we have indicated, the strategy will lead to.

Thank you very much for taking the time to join us today and we look forward to speaking with you and updating you in February and we would very much welcome your calls through IR if there are any follow-on questions. Thank you very much.

End