

Group Chief Executive's Statement

For Centrica, 2016 was a year of robust performance and progress in implementing our customer-focused strategy. We delivered our key objectives including improved safety performance, better customer service, and more innovative offerings and solutions, while repositioning the portfolio, building capability and driving significant cost savings as we build a platform for the future.

CENTRICA IN 2016

2016 was a very busy year for the Centrica team, but they have delivered a lot, and Centrica enters 2017 a stronger company, with encouraging underlying momentum and positioned to deliver longer-term returns and growth.

Our stated purpose is 'to provide energy and services to satisfy the changing needs of our customers'. But, as that mission statement also recognises, the nature of the world in which we operate is evolving rapidly and we need to respond equally fast if we are to survive and prosper.

During the year, we made a good start in the fundamental repositioning of Centrica by focusing on our customers, in line with the 2015 strategic review of the business, and concentrating on making ourselves more efficient and improving capability in the key functions which will allow us to deliver for them and build a real competitive advantage.

It is by no means an easy task and we are still in the early stages of the process. But because of the difficult choices we have already made, and specifically the refocusing of the company and the significant efficiencies

we have been able to unlock, we have given ourselves the time to establish the capabilities necessary to pursue growth. We mustn't waste that opportunity and we have exciting plans, but the world of energy and services is changing rapidly.

There are three shifts driving change in the energy market and in our business. The first is the decentralisation of the energy system. This arises from more viable technologies and many types of solutions for energy management at the point of use.

The second shift, which follows on from the first, is that customers, communities, businesses and individuals, are gaining greater power to choose and control their energy use.

And thirdly, these trends are being accelerated by digital technology, especially big data and the actionable insights provided by analytics.

Our focus must be on what customers want and how we can best serve them. They want affordable energy; they want choice; they want control and the ability to use less energy; and, increasingly, they want lower carbon. We are very well positioned to deliver on all of these needs.

Finally, the world beyond the customer is also evolving. 2016 has seen some big changes in the political and economic environment. Centrica must be a trusted and constructive partner with governments and regulators, while also pursuing our own goals and the interests of our shareholders.

2016 was a year of solid strategic progress and good performance as we delivered for our customers in a rapidly changing economic, political and competitive environment.

RESHAPING CENTRICA

Against this backdrop, we have been repositioning Centrica to be more customer focused, and reallocating resources from Exploration & Production (E&P) and Central Power Generation towards the customer-facing businesses. The asset businesses remain important to the diversity of our portfolio and therefore our cash flow stability but, in relative terms, we are concentrating more resources on the customer.

In February 2017, we announced a major step in reorganising our customer-facing businesses. We have established two operating divisions, Centrica Consumer and Centrica Business. These two divisions will contain all of our businesses which face the residential consumer and the business customer respectively. We are organising to respond to their changing needs. In addition to these two customer-facing divisions, we will continue to develop our portfolio in E&P and in Centrica Storage.

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Iain Conn

Group Chief Executive



If we are to grow the business and enter new markets, we need to get our basic level of effectiveness right. So, we have tackled duplications and inefficiencies and we will continue the journey to simplify and standardise how Centrica works. Altogether, our reorganisation programme has so far required a direct like-for-like headcount reduction of around 3,000.

I recognise the significant challenges faced by colleagues over the last two years. The Centrica team has performed very well in extremely difficult circumstances. But we are now more resilient and adaptable to the external environment and all the internal changes we have made are aligned to achieving the purpose and strategic goals of the Group. We are now in a much stronger position to deliver for our customers, deliver for our shareholders and ultimately deliver for our own employees.

SAFETY

As we reposition the business, our overriding priority remains safety, compliance and conduct. If we don't get this right, we won't be able to execute all our other plans. Last year we saw a big improvement in customer safety, with the number of incidents falling by a quarter. Recordable and lost time injury frequency rates among our own people also fell. Sadly, however, one of our partner engineers was in a road accident in which they tragically died. One incident like this is one too many. We continue to focus on building safety capability with our people through effective communication and training. We also pay close attention to compliance and the relationships with all our regulators.

SERVING OUR CUSTOMERS

We must ensure we satisfy our customers and deliver operational excellence every day. To this end, we are investing £50 million in improving customer service, we have taken on more call centre advisers and we have increased the number of their training days. We try to make sure that our customers can always speak to someone who truly understands their needs.

Our continued focus and investment in customer service has resulted in higher net promoter scores and significantly lower complaint levels across our UK, Ireland and North America customer-facing businesses.

We aim to be clear and competitive on bills and pricing. We committed to freeze our standard tariff, one of the cheapest on the market, for the entire Winter 2016/17 period. We have since extended this freeze until August 2017 just as other providers

are putting their prices up. Bord Gáis Energy also cut household gas and electricity costs by 2.5% and 5% respectively, making it the only supplier in Ireland to have reduced prices three times since February 2015.

HUMAN CAPABILITY

Centrica will only grow and prosper if we have the right people and invest in human capability across the company. Regrettably, but understandably in the light of our restructuring, we suffered a decline in employee engagement last year. We're committed to change that and foster an engaged, diverse and inclusive workforce which will help us to better understand the changing needs of our customers.

We pay at least the Living Wage to all our UK employees and we continue to train thousands of British Gas engineers and apprentices every year. We are also diversifying our talent pool through the Movement to Work scheme which helps young, unemployed people secure the skills they need for the workplace. Since 2014, we have provided 700 training placements, of which 60% gained permanent employment. As a whole, along with our partner organisations, Movement to Work has trained over 50,000 people and 54% of them have secured some form of employment in the workplace.

In 2016, we launched Spectrum, our Lesbian, Gay, Bi-Sexual & Transgender Plus (LGBT+) employee network which, together with our networks for women, carers and parents, provides a vital source of support for our people and ensures we listen and get feedback on how we can be more inclusive as an organisation.

Despite all of the organisational change, across the Group we have been focusing on building capability and ensuring we have the processes and tools to compete and serve our customers for the long-term.

You can read more about our people and some of their stories on pages 32 to 35 of the Annual Report.

TECHNOLOGY & INNOVATION

Reshaping the business is not simply about efficiency and structure, it is also about building new capabilities for the future. And here we laid some strong foundations in 2016.

We are working hard to understand what our customers want and to develop new technology and services to provide it. We are pioneers of the Connected Home. In the UK, we have over half a million users

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Group Chief Executive's Statement continued

of our Hive connected hub. Hive customers can now use voice control, through Amazon's Alexa Voice Service, and Hive products are also being sold in North America.

Our customers are seeing tangible benefits. Our HomeEnergy FreeTime tariff for smart meter customers provides free electricity 9.00am – 5.00pm on a Saturday or Sunday, which can save an estimated £60 per year. And our Boiler IQ offering provides early warning of faults with heating or hot water.

Our Distributed Energy & Power (DE&P) business has been boosted by a first full year's contribution from Panoramic Power, a leading provider of wireless, device-level management solutions, which is helping our business customers to take control of their energy by giving them the tools to monitor, operate and optimise their own assets. Distributed energy is growing, altering the traditional supply model, and increasingly consumers are becoming 'prosumers', generating their own energy.

We have made strategic, value-creating additions to our technological capability. Last year we acquired Flowgem, which specialises in water leak detection; Neas Energy, a leading Danish provider of energy management and optimisation services for decentralised and renewable assets; and ENER-G Cogen, an established supplier and operator of Combined Heat & Power.

This year we will start a pioneering £19 million trial in Cornwall, which will see the creation of a virtual marketplace to buy and sell energy locally and the installation of new technology in over 150 homes and businesses. You can read more about it in one of our Case Studies on pages 12 and 13 of this Annual Report.

Innovation is a key driver of growth. That is why we have announced the formation of a new unit, Centrica Innovations (CI), to focus our efforts in this area and act as an incubator and accelerator of new ventures. The team will be small, agile and outward looking, drawing on experience from our own businesses, other companies, start-ups and entrepreneurs.

We plan to invest £20 million a year over the next five years (2017 to 2021) (up to £100 million in total) in CI. Our existing Ignite £10 million social enterprise investment fund will become part of the new CI unit.

Find out more about some of our ground-breaking products and services in the Technology & Innovation section on pages 10 and 11 of the Annual Report.

Key Events in 2016

2016

05/02

Centrica announces sale of Glens of Foudland, Lynn and Inner Dowsing (GLID) wind farms

READ MORE ON
PAGE 49 

11/02

British Gas leads with a further gas price cut of 5.1%

21/04

Centrica announces the acquisition of Neas Energy a trading optimisation business

READ MORE ON
PAGES 45 

05/05

Equity placing to access key acquisitions and strengthen the balance sheet in uncertain times

16/05

Centrica acquires ENER-G Cogen a combined heat and power (CHP) solutions business

READ MORE ON
PAGES 14 AND 15 

01/07

British Gas launches innovative new energy plan for smart meter customers called FreeTime

 READ MORE ON
PAGES 20 AND 21

15/09

Hive brings voice-control to heating, lighting and plugs

01/12

British Gas makes commitments to energy customers

30/11

Centrica sells Trinidad and Tobago assets

 READ MORE ON
PAGE 47

15/12

First gas flows from Cygnus

 READ MORE ON
PAGE 47

2017

PERFORMANCE

Operationally, against a background of weak commodity prices, 2016 marked a distinct improvement on the previous year. In a highly competitive market we delivered new customer offers in energy supply and services and were very focused on improving our service levels. Home energy accounts in the UK were broadly flat in the second half, UK Business continued to deliver strong capital inflows, and North America Energy Supply & Services recovered well from a warm first half of the year.

We made progress in reducing the scale of our asset businesses and in simplifying the portfolio. We have now completed our exit from wind power generation, while in E&P we announced the divestment of our Trinidad and Tobago assets. We are targeting the sale of our Canadian E&P assets this year.

In 2016 the Group's financial performance was robust. Adjusted operating profit and earnings were both up 4%, with adjusted earnings per share of 16.8p. Adjusted operating cash flow was up 19% to £2.7 billion, significantly in excess of our 3–5% per annum target from 2015 to 2020 and providing strong underpinnings to that objective. Correcting for one-off working capital inflows and for changes in commodity prices between years, underlying adjusted operating cash flow growth was 14%.

We delivered savings of £384 million as part of the Group's cost efficiency programme, which aims to save £750 million a year by 2020. Organic capital investment came in below the £1 billion limit we set, at around £850 million.

Our net debt was 27% lower at the end of 2016, coming in at £3.47 billion, reflecting a strong cash focus and capital discipline. We have strengthened our balance sheet, and our own sources and uses of cash continue to be more than balanced.

RESPONDING TO CHANGING TIMES

2016 was the year which upset political orthodoxies on both sides of the Atlantic. As an international business, Centrica is not a passive spectator of these events. They affect us and we must manage through them, making an active response to changing and complex issues.

The UK referendum vote in June to leave the European Union and the outcome of the United States Presidential election in November have added to the uncertainties faced by businesses. However, we believe the direct impact on Centrica and Direct Energy specifically of these events is limited in the short term.

As far as the UK's withdrawal from the EU is concerned, many details of the implementation process remain unclear. Extricating ourselves from all the European treaties is a task of immense complexity. But I hope that, despite the difficulties ahead, the UK will find a pragmatic way to deal with the issues, and Centrica is well-positioned to manage any market impacts.

Our focus continues to be understanding what the result means for energy and other business regulations. As the UK is now a major energy importer, what happens in the European energy market will ultimately affect the price consumers in the UK pay for their energy. We will continue to engage with the UK Government and the European Commission as they move towards a resolution.

A strong and open trading relationship with the US is vital if we are to continue to prosper as a nation and a business. Free trade is fundamental to global prosperity and to the efficient functioning of international markets. It is important for the UK and the US to maintain transatlantic alignment on markets and regulation, so as to minimise distortions and to safeguard the access which businesses need.

US climate change policy is now in a state of flux. In the UK, we continue to support the Government's policy aims of decarbonisation, security of supply and affordability. We are not a passive partner. In fact, our focus on customers, in providing them with more insight and more tools with which to use less energy and to have more choice to produce, store and save it, means we are a major enabler of the response to climate change.

We welcome the publication of the UK Government's industrial strategy. This represents a unique opportunity to forge a new partnership between businesses and the Government; a partnership where the Government focuses on creating the conditions for businesses of all sizes to grow and flourish across the UK; and where businesses invest to upgrade our economy for a post-Brexit world.

But the Government must also take the lead in tackling one of the major burdens on the UK economy: productivity. The UK lags US and German labour productivity by 30 percentage points, France by over 25 and Italy by nine. To tackle this, we need to upgrade our economy by investing in infrastructure, jobs, skills and technology. We intend to play our part at Centrica.

2016 brought greater clarity on the regulatory front, with the Competition and Markets Authority (CMA) publishing the final report

on its investigation into the UK energy market and the UK Government confirming reforms to the UK Capacity Market.

We have supported the CMA investigation throughout the process, even when we disagreed with some of its conclusions, and we are now actively implementing its remedies. Changes to Retail Market Reform rules, especially the increase in the number of tariffs we can offer, will also allow us to provide more choice for our UK Home customers.

The proposed reforms to the UK Capacity Market will bring on more generating capacity earlier than planned and improve the return to investors. Three of our new distributed energy projects and the replant of our Kings Lynn A power station all cleared the capacity market auction in December, in addition to our existing Langage, Humber and Brigg gas-fired power stations and the UK nuclear fleet.

OUTLOOK

Centrica made significant progress and delivered robust performance in 2016. We delivered our key objectives while repositioning the portfolio, improving capability and driving significant cost synergies as we build a platform for the future.

Looking ahead, we are confident that the trends we have identified are the right ones and our response ensures we are well positioned to compete and deliver for our customers. We will place increasing emphasis on developing and delivering new products and services for our customers and turn our eyes more to growth in a complex world.

We will continue to concentrate on:

- High standards of safety, compliance and conduct;
- Customer satisfaction and operational excellence;
- Cash flow growth and strategic momentum;
- Cost efficiency and simplification; and
- People and building capability.

We will continue to strengthen the company and to pay an attractive level of dividends to our shareholders.

Through all of this, we will be able to deliver for our customers, for our employees, and for our shareholders.

Iain Conn
Group Chief Executive
23 February 2017