Mark Hanafin - Strategic Review

Strategic Review - Centrica Energy

The world has changed, the coal plants are closing, the markets are much more liquid, and that driver for vertical integration has changed. So we've had to take a very clear look at what is the role of E&P in the portfolio and we've decided that it is providing a very valuable role, it does provide scale and robustness to our balance sheet to balance the very large commitments in the downstream, but it doesn't need to be as big as it is. And what we've concluded by looking at modelling the portfolio and also looking at how much capital we want to deploy in E&P, we decided it needs to be about a third smaller than it is today.

Production & Capital Expenditure

We're currently running at something like 75 million barrels of oil equivalent per year. We think the optimal size for E&P and Centrica Group will be somewhere in the 40 – 50 million barrel oil equivalent per annum size, and that will mean much lower capital expenditure. We think that in terms of organic capital for maintaining the assets for some of the development projects that we have, in the coming years we'll be spending four to five million pounds, and then probably every third year or so on average, we may do a bolt on acquisition to help maintain production in that target band. So overall, probably on average over a number of years, around the 600 million level, which is probably about half what we had been investing in recent years in E&P.

Geographical Footprint

In terms of geography, we have to think. With a smaller E&P business, are we going to be spread too thinly, and do we need to focus? That's why we've said Canada should be non-core going forward; partly a question of focus, but also the perspective that the North American market has changed quite dramatically with the collapse in oil prices at the beginning of the year. It's dragged down oil and gas prices quite significantly in North America. When we look at the North Sea, we have some important assets in the Netherlands and in the UK. We will need to optimise those. We will need to continue operating them, getting the most from them in terms of operational efficiency, but the bulk of our capex for maintaining the size of the business will be targeted at Norway where we've developed an excellent business.

Power Generation

We see a trend from centralised generation to de-centralised generation, and when we look specifically at centralised generation in the UK and generally in OECD countries, we don't have confidence that we would be able to invest there and make acceptable returns. The markets are changing, you have all of the intermittency from renewables, and it's very tough to see how you can be confident in making good returns in those.

Costs Efficiencies

The Group efficiency programme of course will affect Centrica Energy, as it will the rest of the group, but in some very specific areas. The changes in the Group strategy will mean that it will be possible to simplify Centrica Energy, reduce the number of layers and management levels and just simplify the governance of that business. That's one area. The second area is that changing mix in assets will lead to other opportunities to reduce cost, and the third area is E&P and we made a commitment at the beginning of this year as a response to the low oil prices to reduce our opex, reduce our capex in E&P, and get us to a cash flow positive over the next two years. That's well on course and clearly we will continue to follow through on that.

Growth Opportunities

There is growth potential for Centrica Energy and it comes from a number of areas. First of all in marketing and trading we see growth coming from LNG. We're building our trading capability globally as we speak in LNG cargoes. The second area in trading that we look to grow is our route to market services where we offer to sell commodities on behalf of customers, whether it be wind farms or other assets and provide risk managing services, and we think we can expand that activity. The second area is in E&P where, despite shrinking in size, we see the supply chain cost reduction and the ultimate recovery in prices at some point, leading to some potential cash flow growth there. And thirdly, very critically, distributed energy. When you consider the elements of distributed energy from energy efficiency, flexible generation, new technologies like battery storage, energy management systems, and all of the trading and optimisation that goes with that, we're very well positioned for those trends.