2018 was another year in which we had to navigate key uncertainties in our operating environment, including volatile commodity prices and an impending price cap in the UK energy market. Our focus has been on what we can control, driving underlying performance delivery and ensuring financial discipline as we continue to prioritise our resources towards satisfying the changing needs of our customers in energy and services. The Centrica team did all of this well and ensured we did not take our eyes off our top priorities of safety, compliance and of course improving the customer experience.

Ensuring the safety of our people, partners and customers is of huge importance to Centrica. We delivered a significant improvement in our process safety performance in 2018, particularly in our Morecambe and Centrica Storage operations, where we had 0.06† Tier 1 plus Tier 2 process safety events per 200,000 hours worked relative to 0.14 in 2017. This puts us in the top quartile of UK companies. Driving safety improved and customer injuries were reduced by over 10%. However, our personal and occupational safety performance did not improve overall with a total recordable injury frequency rate slightly higher than in 2017, due in large part to musculoskeletal injuries in our smart meter operations in the UK.

For our customers, across both Consumer and Business divisions, we have been focused on increased personalisation of offers, increased digitalisation of the customer experience and customer journeys, and provided new propositions and services which our customers clearly value. At the same time, enhanced segmentation has allowed us to place a stronger focus on customer lifetime value. In both divisions, we have continued to invest in customer service and our Net Promoter Scores have been stable.

For our shareholders, we remain committed to delivery of long-term shareholder value through returns and growth. We fully recognise that, following our disappointing Trading Update in November 2017, we began 2018 from a low base and once again the year had its fair share of challenges. From that starting point we did make some progress and in relative terms, Centrica’s total shareholder return during the year was competitive when compared to the FTSE 100.

Our financial performance in 2018 was mixed. At the headline level, we delivered resilient performance with adjusted operating profit up 12% at £1.39 billion and adjusted operating cash flow and net debt within our target ranges. Adjusted operating cash flow was above the midpoint of our target range at £2.24 billion. However, volumes in Spirit Energy and Nuclear were disappointing and recovery in North America Business was slower than expected.

As we begin 2019, we face an unusual combination of headwinds including a larger than expected impact of the UK default tariff cap, continuing lower volumes in Exploration & Production and Nuclear, and higher forecast cash taxes. These headwinds will be partly offset by significant continuing efforts to drive cost efficiency. However, this means that, at prevailing forward commodity prices, our 2018–20 target range for average adjusted operating cash flow of £2.1–2.3 billion is under some pressure. In these circumstances, we are targeting adjusted operating cash flow in the range £1.8–2.0 billion at current forward commodity prices, which have fallen significantly over the past five months and assuming normal weather patterns. This means that on current projections, after the first two years of our 2018–20 three-year performance period, we would still be at or slightly below the bottom end of our target range. We did signal a year ago that there could be particular pressure in 2019, especially in the circumstances of a then-unknown price cap in the UK.

† Included in PwC’s limited assurance engagement. See page 238 or centrica.com/assurance for more details.
In response, we are taking actions to strengthen the balance sheet and improve the outlook for 2020, including driving cost efficiency hard, being disciplined in our capital spending, and targeting further disinvestments, and as a result, net debt levels remain underpinned.

In February we announced that we will be making additional non-core disinvestments totalling £500 million in 2019, starting with the agreed sale of our Clockwork Home Services portfolio in North America for £230 million. We expect capital reinvestment in 2019 to be around £1.0 billion as we drive quality and choice into our investments. We are also targeting £250 million of efficiencies in 2019 which would mean delivery of our 2020 target one year early. As a result of these actions, we expect to maintain Net Debt within our targeted 2018–20 range of £2.7–3.7 billion (which has been restated for the effects of IFRS 16). Finally, we are targeting further efficiencies of £500 million per annum beyond the end of 2019 as we pursue being “the most efficient price setter” in all of our markets. These actions will underpin our performance, resilience and competitiveness for the medium term.

This is a challenging start to 2019, and the environment and trading conditions for the rest of the year remain uncertain. We will know much more at the time of the Interim Results in July, including having a much clearer view of the likely outturn of commodity prices for 2019, market dynamics under the UK price cap and the performance of both the Nuclear fleet and Spirit Energy assets, including early indications from Spirit Energy’s drilling West of Shetland. We will also know more at that time about the prospects for a trade sale of our Nuclear investment.

Having reviewed our financial performance, let me turn to our strategy. Centrica’s strategy is built around the underlying trends of decentralisation and decarbonisation of the energy system, customers becoming more powerful and desiring new propositions, and digitalisation which continues to accelerate change in both energy and related services. We are responding by reshaping the Company to face that future and building the capabilities we need to respond to the changing energy landscape and to satisfy those changing needs of our customers. During 2018, we have continued to develop material new customer-facing capabilities in both Consumer and Business, exposing Centrica to an expanding opportunity-set in terms of customers, channels, propositions and geography. We have significantly deepened Centrica’s capabilities in technology, engineering and innovations which in turn are enabling new solutions for our customers. I recognise we have further work to do if we are to overcome some of the competitive pressures on the traditional energy supply businesses and net grow our customer-facing margins overall.

However, we now have access to new growth opportunities outside our traditional, more mature markets and in many of our businesses we are seeing some encouraging indications of stabilisation and growth potential.

In Consumer, our digital transformation programme, which has resulted in more interactions taking place online, has helped to improve the overall customer experience, and our retention rates have shown an encouraging uplift. We have more than two million customers participating in our Rewards programmes, and in the UK this has led to a halving of customer churn. In UK Home energy supply, we saw a reduction of 742,000 customer accounts, slightly more than we had expected due to two price increases during 2018. Combined with the growth in Home Services and Connected Home, total customer accounts in Centrica Consumer fell by 248,000 over the year and in the second half of the year, the reduction was 23,000. This compares to a reduction of 1.4 million accounts in 2017. We saw net growth in consumer account relationships in our in-home services businesses in North America and also in the UK for the first time since 2010. Our total consumer relationships have therefore fallen by less than 1% out of over 25 million in total and we are gaining valuable new customers in products and services with attractive margins, many on a subscription basis.

In Connected Home, the number of subscription customers more than doubled, revenue was up by 60% and we added 444,000 customers, close to our external target of 500,000 and in line with the sort of progress we would expect from a fast-growing business.
In the Business division, customer account numbers were down slightly, and within that, we have seen a good recovery in UK Business with new propositions driving growth in the small and medium enterprise customer segment. Across the division there was a focus on higher value segments in both the UK and North America. In Distributed Energy & Power, our leading indicators showed evidence of significant forward momentum during the year. The order book was up by 51% and order intake by 158% compared to 2017 and we grew revenue by 14%. The acquisitions that we made over the last few years – in areas including wireless energy insight and management (Panoramic Power), combined heat and power generation (ENER-G Cogen), demand-side response (RESTore) and distributed energy management (Neas Energy) – continue to perform better than we had expected, and the capability that they have brought has enabled the creation of our Integrated Solutions Platform with a single user interface. North America Business profitability improved, recovering somewhat from the lows of 2017, but not as swiftly as we had expected. Competitive pressures in electricity retailing in the US remained strong and margins continued to be squeezed. Although total customer account holdings were down 65,000 during 2018, this partly reflects a focus on value over volume, as we optimise customer segments and sales channels.

Along with the undoubted progress, there have been disappointments, particularly in our asset businesses of Exploration & Production and UK Nuclear power generation.

In December 2017, Spirit Energy, in which we own 69%, was established as a separate company in partnership with Stadtwerke München. Oil and gas production from Spirit Energy in 2018 was lower than expected, reflecting unplanned outages and operational issues in both operated and non-operated fields. Our strong focus on process safety has resulted in marked improvement but resulted in longer outages before restarting our Morecambe field. In January 2019 it ran very well. We also are having to re-drill a key well in the Greater Markham area, and we experienced production availability and decline issues in key non-operated fields in both the UK and Norway. Centrica Storage became a producing asset in 2018 and performed very well, both in safety and production terms.

Although production was disappointing, we are encouraged by Spirit Energy’s agreement to farm into Hurricane Energy’s interest in the Greater Warwick Area and to fund a $180 million (£139 million) drilling campaign West of Shetland. Spirit Energy overall is now a sustainable, standalone European E&P operation. The immediate focus is on improving performance, strengthening the portfolio, and creating the option for new shareholding arrangements, either through further industry consolidation or potentially an IPO.

Centrica continues to have a non-operated 20% interest in the existing Nuclear generation fleet in the UK. Performance in Nuclear was affected by extended inspections and outages at the Hunterston B and Dungeness B power stations which resulted in lower output for the year. These issues, and associated regulatory oversight before the stations can re-start are extending into 2019. As part of our strategic repositioning, we announced our intention to divest our 20% stake in the UK’s existing nuclear power fleet by the end of 2020, and a sales process is underway.

Moving from 2018 operations and turning to business development, we are continuing to ensure that we are well positioned to participate in the global natural gas market, and have a diversified portfolio of supplies, as well as the ability to optimise them. We have signed a sale and purchase agreement in strategic partnership with Tokyo Gas to jointly purchase 2.6 million tonnes per annum of liquified natural gas (LNG) from the Mozambique LNG project from the start-up of production until the early 2040s. This is the first long-term LNG procurement contract in Africa for both Tokyo Gas and Centrica. This innovative joint procurement approach takes full advantage of Mozambique’s central location between Europe and Asia, assisting both Centrica and Tokyo Gas to proactively manage demand fluctuations across regions with different market dynamics. We have expanded North America Business through small acquisitions, including a portion of BP’s US marketing operation and the retail energy provider Source Power & Gas. In Distributed Energy & Power we made two small acquisitions to expand our solar solutions capacity in the US. In Connected Home, we continued to expand our retail channels beyond the UK, with Hive
products now available for sale on Amazon in the United States, Canada, and in Italy and France. We are also expanding the product portfolio, launching propositions and services such as Hive Link focused on providing peace-of-mind to our customers. Just as we are building new business, we must also have a strong focus on optimising our portfolio of businesses and ensuring we are delivering attractive returns from positions in which Centrica has a competitive advantage. We announced the intention to divest of a further £500 million of non-core positions, and as a first step have agreed the sale of our Clockwork franchise services business in North America for £230 million. Following a strategic review, we concluded that it has been hard for us to grow this business, to cross-sell other propositions through it, and that this branded portfolio would naturally fit with another owner intent on building a franchise business in the US. The sale of Clockwork will also help with our priority to simplify our portfolio of brands and channels, to make Centrica more coherent for our customers. We also plan to dispose of further non-core assets during the year, including possible capital recycling in both Exploration & Production and in Distributed Energy & Power.

Given the competitive pressures we are dealing with every day, we continue to have a very strong focus on being as efficient as we can be, so we can serve our customers well and be as competitive as possible. In our core cost efficiency programme we delivered a further £248 million of savings in 2018 plus additional savings in other areas of £38 million. That means we have now taken nearly £1 billion a year out of our like-for-like cost base since 2015. 2018 total controllable costs are 7% lower than in 2015, with the Group having more than absorbed the effects of inflation, foreign exchange movements and additional operating cost investment in growth. We have much more to do in our efficiency programme and in 2019 we intend to deliver a further £250 million of savings. That means that we will have exceeded our 2020 target of an additional £500 million savings a year early. At our Preliminary Results in February, we announced a further £500 million per annum of additional efficiencies beyond the end of 2019 as we target becoming the “most efficient price setter” in all of our markets. Delivering on this would take our total like-for-like efficiency delivery relative to a 2015 baseline to £1.75 billion per annum by the end of 2021.

I would now like to turn briefly to the broader context in which we operate. The trends I outlined earlier, which we identified when we launched our new strategy in 2015, are even clearer today and are playing out in line with our views at the time. We are in step with where the energy world is going and the services which our customers desire, and we believe our 2015 strategy is still valid today and plays to the core strengths of the Company. Our aim is to be an international 21st-century energy and services company and to deliver for the changing needs of our customers. There are clear signs that customers want more than energy supply alone, and combining energy supply with other services creates a valuable needs-based set of propositions for them. The evidence is clear that the unit gross margins of energy and services relationships are higher than in energy supply alone. That is what our strategy is all about – shifting the centre of gravity of our relationships with customers towards more value-added services. While there is much yet to be done, we are beginning to demonstrate our ability to become the customer-facing, international energy and services company that we set out to be when we launched our new strategy in 2015.

“We have refreshed our point of view on climate change and set out a new ambition to enable all our customers to use energy more sustainably.”
We have introduced a new set of Responsible Business targets as we respond to the changes in societal expectations. Our Responsible Business Ambitions set out long-term targets to enhance our impact in areas where we have the greatest responsibility and where we are well placed to make the biggest difference. Our strategy is to satisfy the changing needs of our customers, deliver long-term shareholder value through returns and growth, be a trusted corporate citizen, an employer of choice, and a 21st-century energy and services company.

To live up to this, our key responsibilities include responding to the challenge of climate change, innovating to improve our customers’ lives, developing our workforce to deliver for our customers in the long term and create stronger communities.

As part of this, we have refreshed our point of view on climate change and set out a new ambition “to enable all our customers to use energy more sustainably”. Our actions will focus on three areas: helping our customers reduce emissions in line with the goals of the Paris Agreement; enabling a decarbonised energy system; and reducing our own emissions in line with Paris. We have clear ambitions out to 2030 in each of these areas, underpinned by shorter-term targets. For example, having reduced our own emissions by 80% over the last decade, we are targeting a further reduction in our internal carbon footprint of 35% from 2015 to 2025. We have other targets to help our customers reduce their emissions through both our direct and indirect actions, and to deliver flexible distributed and low carbon technologies and provide system access and optimisation services to them. In line with the Task Force on Climate-related Financial Disclosures (TCFD), we are committed to continuously improving our climate change disclosure to show how our strategy reduces risk and delivers a smooth transition to a lower carbon future.

We have devoted considerable effort to prepare for the UK exit from the EU, with a focus on the risks of a ‘no deal’ outcome for the Group and our customers. While the energy sector is likely to be less affected than some other parts of the UK economy, there are still some material issues for us, both financially and in ensuring business continuity. In financial terms, we are exposed like many others to a weakening of sterling, which would also impact the cost of energy for our customers. In continuity terms, we have taken precautions such as increasing UK stocks of EU-sourced equipment to maintain customer service in the event of delays at UK ports. Our Energy Marketing & Trading business, which operates widely across Europe, also took measures to maintain those operations in a ‘no deal’ scenario.

We have many EU nationals who work for Centrica in the UK. So, we were pleased with the Government’s proposals for Settled and Pre-Settled Status for EU nationals, which will apply even in a ‘no deal’ scenario, and the subsequent decision to waive any application fees. We warmly welcomed the EU Withdrawal Agreement provisions aimed at maintaining the Single Electricity Market on the island of Ireland, in which Bord Gáis Energy participates. We were also very pleased to see energy included within the scope of the proposed Political Declaration on the future UK relationship with the EU. This paves the way for further detailed negotiations after Brexit to maintain a close energy and climate relationship supporting cost-efficient, clean and secure supplies of energy.

Key events in 2018

January
Centrica Innovations invests in EtaGen
Read more about EtaGen on Page 60

March
Centrica announces expansion of Local Heroes to include painters, decorators, locksmiths and tilers

June
Tokyo Gas and Centrica sign Heads of Agreement
Centrica invests in Barrow Green Gas, the UK's largest green gas shipper
Read more in the Business Review on Page 26

February
Roll-out of Centrica Business Solutions in North America

April
British Gas announces default tariffs to increase due to rising wholesale energy and policy costs

July
Centrica Business Solutions launches in Ireland
Read more at centrica.com/ireland
The price cap on default energy tariffs in the UK came into effect on 1 January 2019. We regret that we were unable to persuade the Government and regulator not to implement the cap which we do not believe is a sustainable solution for the market, and is likely to have unintended consequences for customers and competition. We presented a clear alternative with our ‘14-point plan’ to reform the retail energy market, which included a proposal to end all Standard Variable Tariffs and open-ended contracts, a step which we believe would benefit all consumers and which we have taken unilaterally for new customers. Despite the significant near-term negative impact of the price cap on our earnings and cash flow, particularly in 2019, we are focused on delivering a sustainable and attractive business in UK energy supply and have already implemented a number of mitigating actions, including cost efficiencies of £20 per dual fuel energy supply customer by 2020. However, Ofgem’s revision to the methodology for calculating supplier wholesale costs is expected to result in a one-off negative adjusted operating profit impact of around £70 million in the initial period of the cap in Q1 2019. In December, we announced we would be seeking judicial review of Ofgem’s decision relating only to the treatment of wholesale cost transitional arrangements for the first period of the cap. Based on the normal timelines for judicial reviews we would expect the process to be concluded in six to nine months.

During 2018, we saw several significant changes in the leadership of Centrica, both at Board level and on our Executive Committee. I would like to welcome Charles Berry as Chairman and to thank Rick Haythornthwaite for his leadership of the Board over the last six years, and his guidance and support for me over the last four. I would also like to thank the outgoing Executive Directors – Mark Hodges, Mark Hanafin and Jeff Bell – for what we have achieved together.

Our new team is already in place, filled through both internal and external appointments. I am confident that we have the leadership needed to guide Centrica through the next phase of our development during 2019 and beyond.

Finally, I want to thank the whole Centrica team for the extraordinary amount of hard work which they have put into the business as they faced a very difficult set of circumstances, including uncertainty from continuing high levels of organisational change and cost reduction. Centrica’s Values – Care, Collaboration, Courage, Agility and Delivery – are becoming broadly embedded in the organisation, helping to guide all of us as we work to create the excellent customer-facing company we all wish to be part of. As regards employee engagement, although I recognise that we still have a long way to go in making sure that everyone at Centrica feels truly valued, we focused strongly on our people’s feedback from 2017 and I am pleased that we have improved our engagement scores. Improving employee engagement will remain an area of focus.

Iain Conn
Group Chief Executive
20 February 2019