

Centrica plc – Rough reopening analyst and investor call

Transcript

Chris O'Shea, Centrica

Good morning, everyone. Thank you very much for joining the call, especially at short notice. I hope you're all well. I'm joined today at the Easington gas processing plant in East Yorkshire by Martin Scargill, who is the Managing Director of Centrica Storage Limited. I'm really excited that we've announced this morning that Rough is now operational as a gas storage facility again. So much so that I thought it would be worth providing a bit more colour to the announcement. I'm going to spend about 10 minutes going through the current status and also touch upon the potential longer-term future for Rough as a hydrogen storage facility. Martin and I would then be delighted to take any questions that you may have. Obviously, the more difficult ones for Martin and the easier ones for me!

So how have we got to where we are today? No doubt, you'll recall that until 2017, Rough was by far the UK's largest gas storage facility, making up around 70% of total UK capacity of about 200 billion cubic feet (bcf). However, having identified well integrity issues and after assessing the economics of seasonal gas storage, we concluded that it would not be economic to make the significant investment required to continue to operate Rough as a gas storage asset at similar levels of capacity. We were granted permission to produce all recoverable reserves, and we've been operating Rough as a gas production facility for the past five years. It hasn't been mothballed at any point at all. It has been fully operational, fully staffed, and working all the way through.

For the past couple of years, we've been investigating the possibility of extending the life of Rough, essentially by repurposing it as a hydrogen storage facility. That would require reopening it first as a methane natural gas storage facility and then converting to hydrogen over time. In July, we were granted a 10-year storage licence by the North Sea Transition Authority. At the end of August, we were given all necessary permissions to recommence storage operations at the site.

Rough is going to provide around 30 bcf of gas storage capacity this winter, which is around nine LNG tankers worth. We've had an extended commissioning period for the facility, and we've currently got well over 20 bcf of gas in the field. That includes around 14 bcf of indigenous reserves that were still in the field at the end of June. Rough immediately becomes the UK's largest gas storage facility once again, and it adds more than 50% to the country's previous capacity of around 60 bcf. Rough will play an important role this winter in the UK. It will help to balance the UK's gas market. We've got enough visibility of gas prices over this coming winter to be able to run Rough with no need for a regulatory support model. We'll add value through injecting gas when prices are low, like they are today, and then withdrawing that gas

when the prices are higher, as we expect them to be in the coming months as it gets colder.

However, our long-term aim remains to turn Rough into Europe's largest long-duration energy storage facility. Initially storing methane and subsequently converting to hydrogen storage, helping the UK reach a net zero electricity system by 2035 and the decarbonisation of the UK's industrial clusters, including the Humber region, by 2040. We intend to make Rough the largest hydrogen storage facility in the world.

As we said back at our interim results in July, we need to spend around £150m to increase the storage capacity to around 60 bcf for next winter. The total project, including the cost of converting Rough to store hydrogen, would cost in the region of £2bn. I'll reiterate that we would be highly unlikely to invest such sums on a merchant basis, given that it's impossible to predict future commodity prices and, more importantly, seasonal spreads with any certainty. Any future investment is dependent on a regulated return model. We're not looking for government money. We don't want it, we haven't asked for it, we don't need it. We can fund this either ourselves or with partners. We're simply looking for a model, such as that which is used with existing strategic UK energy assets, like the interconnectors, to boost UK energy security.

The chart you see here shows the daily injection of withdrawal volume since we started our commissioning operations. We've gradually built up to injection levels averaging over 200 million cubic feet or 2 million therms a day, having also tested the assets withdrawal capability during September. After all, we want to make sure we can get the gas out of the ground having put it in there. Rough being back on means we've been able to buy gas from the spot market while selling it forward for later in the winter, capturing price spread and creating significant value both for UK energy consumers by helping to balance supply and demand in peak times, and obviously, for Centrica shareholders. Running Rough as a storage asset this winter also provides optionality to do the same again for the next winter, with a similar level of potential capacity without the need for additional investment. However, we don't know at this stage whether this is going to make economic sense. That's why we've been in discussions about a regulated return model.

We've included a couple of slides with some detail on the history of Rough and Easington. Both of which have been part of the Centrica family since 2002. We own 100% of these assets. Also, on the unique characteristics of Rough, which makes it the only proven large gas storage facility in the UK. The slides are available on the Centrica website and I won't go through them in too much detail, but there are a couple of points to highlight on this slide. The Easington Gas Terminal remains an important part of infrastructure for both Rough and the UK as a whole. It's capable of processing 1.6 bcf of gas per day, equivalent to approximately half an LNG tanker or around 20% of average UK daily gas demand. Our management team, including Martin, who's here with me today, has a long and proven track record in gas

infrastructure development and safe operations. They know what they're doing. They've been doing it for decades. The future of Rough is in very safe hands.

These are some of the facts on the unique characteristics of Rough. We call it the Goldilocks reservoir. It meets all of the requirements on temperature. It's not too hot, and it's not too cold, it's just right, both for methane, but more importantly, for hydrogen. It's got the right requirements on dryness, on size, on proximity to land. It's very close to the coast, it's a really nice size, and we don't have water or other liquids in there. It remains the only proven offshore gas storage reservoir in the UK. It's these characteristics that also mean that Rough is well placed to play a role in a hydrogen future, and it does support the UK hydrogen strategy, which in April of this year doubled the target for hydrogen production from 5 gigawatts to 10 gigawatts by the end of this decade in the next eight years.

Again, there's further detail on this slide, but the key takeaway is that the doubling of the capacity is the thing that should mean that Rough is required. It is, in our view, impossible that this heightened target for hydrogen production can be met without hydrogen storage capacity. We believe Rough is the only meaningful material option available. Once you start to use hydrogen you must have an uninterrupted supply, and that means you must have storage.

Rough is also incredibly well located, given the proximity to the combined East Coast Cluster, which is responsible for around half of the UK's industrial CO2 emissions. Rough has got the potential to play an incredibly important role in the decarbonisation of the Humber region, and by extension, the UK.

Before I move to any questions you may have for Martin and I, let me briefly summarise. Having been granted a licence to store gas at Rough again, we've got around 30 bcf of potential capacity this winter. Given that we've been injecting gas since September, we've currently got well over 20 bcf in the field already. The visibility of prices means that we don't require a regulatory support model for this winter. However, longer term we will require the right regulation to be confident enough to invest the material capital in this project that we would like to invest to create thousands of jobs in the UK, to reduce prices for consumers, and to help deliver the UK's hydrogen targets.

We will continue discussions with the UK Government. We're not asking for any government investment, just the appropriate regulatory framework. Everyone I speak to, whether in government, in opposition, in NGOs, everyone agrees that we need Rough. I'm really hopeful that we'll be able to align upon a regulatory framework which underpins the investment needed to materially boost the UK's energy security, keep consumer prices down, enable the UK's hydrogen economy, and return us once again to a country which is a net exporter of energy, which in my view would transform the UK economy.

I'd just like to say thank you very much for your time. We're now happy to take any questions that you might have.

Question 1

Mark Freshney, Credit Suisse

Chris, if we do the maths, if we look at the National Grid long-term storage, we can see what you've been injecting. We can work out that you can fill up this storage facility at 150 pence per therm and take it out in Q1 at 370 pence per therm. We can work back through the maths and get to some very, very high numbers. My question to you is, is that right? Why would you not make order of magnitude £400-500m of post-tax profits from this injection trade? Secondly, what is your revenue recognition policy? In which years will you recognise? Will you have to mark-to-market the gas as at 31 December, or the profits? How should we think about revenue and profit recognition?

Chris O'Shea, Centrica

Kate and I spoke about whether Kate should be on the call, and I said probably not, too many finance questions, so Kate's not on the call. If she's listening to it, she'll be going absolutely mad if she thinks I'm going to answer a mark-to-market question. As far as I understand, what will happen is we will recognise the revenue when we withdraw the gas. I'm getting nervous here, I think it's covered by what's called the own use exemption. Remember, I'm about 15 years out of date on this stuff. But I don't think we'd recognise – it should be recognised when you withdraw it. Obviously, on the capacity on the prices and the like, we need to see where prices are when we withdraw this. As you know, I've long been allergic to any kind of profit forecast, and I wouldn't be anywhere near as good as you are at your job in doing that, so I'm sure you'll come to the right number.

Mark Freshney, Credit Suisse

If I could just follow up with a question for your CSL manager. On the hydrogen, you mentioned 10 terawatt hours of hydrogen storage, which I believe is for £2bn of capex, but when I look at Rough storing methane, on my maths, and I've got a cheat sheet in front of me, actually, so it's not really my maths, but at 180 bcf of gas, Rough stores 54 terawatt hours, and you're talking about 2bn of capex to only store 10 terawatt hours of hydrogen. Is it correct that there's a fairly big de-rating in the energy content that Rough could store moving to hydrogen?

Martin Scargill, Centrica Storage Limited

The first thing you need to add to your cheat sheet is that the energy density of hydrogen is a third of that of methane, so anybody storing hydrogen, their store got two-thirds smaller overnight by changing the fluid. The other number probably to add to your cheat sheet is the number we're putting out there in terms of 10 terawatt hours for Rough is utilising 120 bcf of its working capacity, which could go higher. It could go to 200, but we've pitched it in around 120. We think that's a good sweet spot for what we see is needed in the market but could go higher.

Chris O'Shea, Centrica

That in a way is saying that your cheat sheet is probably quite right. I learnt a lot that engineers tend to be quite conservative, so I tend to round up something that engineers tend to round down. By and large, I think that's saying if you worked out the energy density, and you go from 120 to 180, which is probably, if I'm being honest, going from 100 to 200, then you've got just about the right number. So, 10 versus 54. Your numbers are pretty much right.

Mark Freshney, Credit Suisse

Not often the case but thank you very much.

Chris O'Shea, Centrica

Ah, you're being modest!

Question 2**Martin Young, Investec**

You mentioned £150m in respect of dealing with the methane storage side of things. How much of that has already been spent to take you up to 30 bcf, and given the comments around the lack of visibility for next winter, would you be prepared to spend the balance on a merchant basis, or are your comments about regulatory support applicable to the second phase of the methane spend? Then the second question is, we live in some strange times at the moment, and we have an ever-changing government that is doing very strange things, and you could argue that some of those strange things fly in the face of dealing with the much-needed energy security that this country has got. Can you rule out the possibility of government getting interested in a grab of spread profits from storage facilities like Rough?

Chris O'Shea, Centrica

The £150m is all for the increase in capacity for next year. That's a lot of money and what we are looking for in Rough, what we think is the right thing to do, is to have a long-term deal to bring this thing back for 40 years. Let's talk about the next 40 years, not the next 40 weeks. The likelihood of us spending £150m on spec to increase capacity from 30 bcf to 55-60 bcf or so is quite limited. We do need government backup. We've already invested a reasonable amount.

In terms of commenting on the likelihood of government doing stuff, I don't want to get drawn on that at all. It's really for government to decide what it is that they do. The thing I would always come back to is governments who decide to take profits from companies in good times may well scare away investment. As you know, I've been very open on this. My view is that to transform the UK energy system, we could have contracts for difference, and that could achieve something, which is an energy market that can work for the consumer, but I do worry about the idea of governments doing this because what that would suggest to you is that governments are going to go after all the energy traders. What about the energy traders that trade in the UK

markets but are not in the UK? You know this better than I do having worked in Ofgem.

I think that what the current situation calls for is cool heads. Whenever I've got any conversation with government, what I always say is if we think about what we're trying to achieve, then let's try and find the best way of achieving the objectives rather than instantly run to talking about top slicing revenue and the like. We're actively engaged with this. I hope that government does the right thing, but I wouldn't want to be drawn on what they may or may not be considering. That's been proven to be a fool's errand over the past while.

Question 3

Dominic Nash, Barclays

I've got a couple of questions, please. One sort of technical, which is Rough used to have or did have a lot of cushion gas in it, and when you decided to decommission it, you said we're going to run it down as a normal gas producing field going forward. What sort of cushion gas do we need to put back in or have you put back into Rough, and how does that get put on the accounting? The second question I've got is, I think last time that we met up, I think you mentioned that you were hoping that fracking might be coming back onto the table. That's obviously been kiboshed in the last few days or so. What are your thoughts really about the UK Government policy on producing indigenous fossil fuels going forward in order to meet the fact that we're still going to be consuming this stuff going forward, or do you think that was an incorrect policy from government?

Chris O'Shea, Centrica

Let me take the fracking, and then Martin can talk about the cushion gas. Remember that any of the gas that we've got in the ground just now isn't recognised on the books other than the gas we've bought, other than the cost of developing this asset. Look, on fracking, my view is if you step back from it, gas is a key transition fuel to get to net zero. Gas is going to be with us, natural gas, for the next 20 years or so. We have to recognise that in order to have the right plans to get to net zero. The very question, which is if you recognise it, if you accept you're going to use gas, where is the best place to get the gas from an energy security point of view, from a cost point of view, from an environmental cost point of view? Firstly, it's probably more expensive to produce shale in the UK than it is to produce gas in Qatar or somewhere else. The environmental cost is probably a bit lower because you're not transporting the gas on ships, so you probably save something there. Then you've got security of supply. Security of supply is undoubtedly higher if you produce it domestically.

I think that the debate on fracking has far more heat than light. When I see it, it's not what I would call a particularly well-informed debate. I'm not in a position to say we should frack. I'm in a position to say my view is that we should have an informed debate about this, and we should have cool heads involved in the debate, and we

should make the right decision based on the cost, the security of supply, and the environmental cost.

As you know, fracking is something that's been going on for decades, so what we're talking about really is onshore gas production from shale rock. That's proven to work. I think that we've just got to step back and say, what is it we're trying to solve? Security of supply is important, and the UK has a lot of indigenous gas. If it becomes the most important thing, I would have thought that the most important thing is to produce domestic gas. But again, people in government have got so many things on that I don't understand fully the pressure that they're under, and they make what they think are the right decisions. I just want a proper, open, and informed debate about it. I just don't think we've had that at the moment.

I'll ask Martin to talk about the cushion gas.

Martin Scargill, Centrica Storage Limited

I'm just conscious of time, so a quick answer. The gas that we put in is all stock. We don't need to top up with cushion gas. The slightly longer answer is the way that we're operating the field is much lower down its pressure envelope, so we're able to reopen the facility at a lower pressure, and we don't need the high levels of cushion gas that we had before.

Question 4

Milo Du, AB Bernstein

I have two questions. The first is on the near-term earnings. Do you have a ballpark number for the near-term earnings getting affected by Rough? Second one is, how long do you think you will operate at 30 bcf capacity? For this winter only, or can continue beyond this winter? And the long-term earnings impact on this bcf capacity?

Chris O'Shea, Centrica

On the near-term earnings, in fact, you guys are very, very capable of doing that, so I don't want to give you numbers that you plug into your model. In terms of operating at 30 bcf beyond this winter, it really does depend on the economics of it all. We have to wait and see how things look. Obviously, we have far better visibility over this winter's price and spread and volatility than next winter, so let's wait and see. Physically, we can operate it at 30 bcf for a while. We can certainly do that physically; economically will be the question.

Milo Du, AB Bernstein

Another one is on the capex. You mentioned for the next year, the number of £150m, and you also mentioned the £2bn investment over the long term. What is exactly the £2bn going to get invested in? In the hydrogen storage or any other investment?

Chris O'Shea, Centrica

The £150m is what would be required to double the capacity, more or less double the capacity, for next year. The £2bn is to get into hydrogen storage. That essentially means that we would redo all of the wells, we would replace the platform, we would replace the jacket and the legs on which the platform stands, we probably would replace the pipeline, so essentially, we'd replace everything but the reservoir and the onshore processing plant, but we'd have to make some modifications, quite major modifications to the onshore processing plant. So, £2bn is a very, very rough estimate of what it is to get to hydrogen storage.

Question 5**Sam Arie, UBS**

Thanks for this announcement, and congratulations. A good development. Thanks for your answers. Can I ask a follow-up on the cushion gas topic? I'll probably make myself look an idiot because I don't understand these storage facilities very well. Are you able to tell us how much cushion gas you had sold before you stopped selling cushion gas and started reinjecting? I don't know if you can tell us that for this year, or maybe total since you started selling the cushion gas, and then we can work out something for this year? I suppose then the next question is, can you tell us how much cushion gas is left in the facility now?

Then my question where I might look a fool but tell me if this is right. Should we think about you now having a new earnings stream, if you like, which is a spread trade on your injections that you're doing now? What you're paying now versus what you sell for next year say, but you have a lost earnings line if you like, which is whatever you were making from selling off the rest of the cushion gas. I don't know, but I guess that's a spread trade versus whatever you paid for it many years ago when it went in. I don't know if it was just in, but if the cushion gas is fundamentally gas that was there anyway, so it's kind of 100% spread. Anyway, my question is, is it right to think that you're going to sort of swap one earnings line for the other? Then, relative to the question on this earlier, it's not so much how much do you make on the new trade, it's what's the net difference between one and the other?

Chris O'Shea, Centrica

It's fair to say that since we converted back to a production facility, we've produced about 100 bcf. You could find that, you'd have to go back and look at the production in CSL, which I think we disclose each year. There's about 100 bcf that we've produced. On the question about the earnings, that is the right way to think about it in terms of we have got a new revenue stream. Now, obviously, we were producing and taking out, and we're no longer producing; we're storing. The way I think about it though is slightly differently to replacing one earnings stream with another. I think about it in very simplistic terms – we bought a storeroom, or we've acquired a storeroom that already had some stock in it, so the indigenous gas that's in there we will produce. We've got over 20 bcf and that includes 14 bcf that's in there at the moment, and so we will withdraw that over time. If we can see the market signals

being there, then we'll replace what is very much a declining asset with one that should be very stable, and if we get the right framework, we'll be here for another 40-odd years. But I do think about it as rather than we stopped production and we start storage, I just see it as we convert to storage, but we're already at 14 bcf in the storeroom at the time, and we've added just a bit under 10 bcf to that since.

Sam Arie, UBS

I'm not sure I totally follow all of that, but I think I get the big picture, and I'll follow up maybe with Martyn on the details. Do you mind if I just throw in a couple of other small questions, and then I'll get off the line? On the long-term capex of £2bn. You pointed out in your presentation, of course, it's a 100% owned Centrica asset, but if you got the framework that you wanted and were looking at a £2bn investment, that's quite a large investment for you on one asset. Is that something you would look to bring a partner on board for? Have you had any discussions like that?

Chris O'Shea, Centrica

Remember, it's not £2bn all at once. That would be over several years. It really does depend. I've always been quite clear I'd like to have more investment opportunities than we have money to invest. I'd love to have that problem. It all comes about in terms of how you defray risk. I wouldn't say I'm jealously guarding the fact that we do this all ourselves. I wouldn't say that we need third-party money. It really does depend what the overall portfolio is. It depends what the other investment opportunities are and what the returns are on this asset.

I hate to leave you confused. To the last one, you're right in thinking that we now have a revenue stream which is basically built around a spread on gas. That is absolutely spot on. It does replace the production revenue stream that we had from Centrica Storage Limited. But my point is that the gas that we would have produced had we just stayed in production operations, we've got a spread on that gas, so that gas is in the ground at a cost of zero, essentially, and you can mark that to market. The way I think about it is the storeroom that we've got today has got over 20 bcf in. 14 bcf of it has a zero cost, and the other, say 9 bcf – I think we've got about 23 bcf – the other nine we've bought over the past six weeks. You can therefore then blend the cost. For the 14 bcf, there was no cost to inject it. That's how I think about it. Hopefully, that's a wee bit clearer.

Sam Arie, UBS

Yeah, very clear. The 14 bcf, which is basically the cushion gas that you'll need going forward, one day you may sell it, but if you do 40 years of running this as a storage asset, it may stay in the ground as cushion gas.

Chris O'Shea, Centrica

To be clear, sorry, that 14 bcf isn't cushion gas; that 14 bcf is withdrawable gas. We had about 14 bcf of producible reserves left in the reservoir. Not cushion gas. That 14 bcf now becomes accessible storage gas.

Sam Arie, UBS

How much is the cushion gas that you have left in?

Chris O'Shea, Centrica

I don't have that number.

Martin Scargill, Centrica Storage Limited

It's still quite a large quantum. It's over 100 bcf. Before storage conversion, the plan was to run the field down, produce that remaining 14 bcf, and shut in at that point. At that point, there would have been still over 100 bcf left in Rough, but it was commercially not viable to extract it. It has a long withdrawal profile. Quite a long skinny production profile.

Sam Arie, UBS

Right, okay. I think that's clear. I'm not going to keep digging on this topic. I know other people have questions but thank you for your answers.

Chris O'Shea, Centrica

No, that's fine. Just think of the 14 bcf as being accessible gas. It's zero cost gas that we can withdraw, and it's in the storeroom.

Sam Arie, UBS

The 14 bcf is what you would have sold if you'd have carried on on the current plan.

Chris O'Shea, Centrica

Yeah.

Sam Arie, UBS

The net for us is to work out what do we think is the NPV of the new storage activity that you're back into and then offset against what you would have got from just selling the 14 bcf on the previous strategy?

Chris O'Shea, Centrica

Yeah, and obviously, we believe the NPV of the new strategy is higher than the old strategy; otherwise, we wouldn't be doing it.

Sam Arie, UBS

Of course. Very good. Thank you.

Question 6

Mark Freshney, Credit Suisse

Me again, sorry, quick fire. Firstly, can you confirm that the CMA removed all the third-party access (TPA) requirements, so you can trade principle rather than actually just offer capacity into the market? Secondly, I remember you had a bunch

of other fields, I think Bains and I think there were three of them you wanted. Caythorpe. Three properties you wanted to develop. I was just wondering what your thoughts were? I think one of them was almost ready to go, but TPA was an issue, so I just wondered whether those were still available to you or whether they're gone? Thirdly, on the safety case, I know that when you took it out of service three or four years ago, it was on a safety case, even though it was uneconomic. I was just wondering why the safety case, why you couldn't operate it safely now, but why there were concerns with admittedly previous managers as to why they couldn't operate it safely?

Chris O'Shea, Centrica

Bains and Caythorpe are gone. No longer for us. We didn't believe those were suitable for storage. Rough is the best game in town, which is why we've kept it. The third-party access, we have an exemption from that for two years. However, if we're not using the access, we do have to offer it up to third party. We're not obliged to offer it up, we can use it ourselves, but if we're not using it, we've given an undertaking that we would allow third parties to use it. We expect, however, to use it. On the safety case, the way to think about it is when this thing was operating at 150 bcf, it was operating at – what was the pressure?

Martin Scargill, Centrica Storage Limited

3,500, so about 250 bar.

Chris O'Shea, Centrica

Yeah, so 250x atmospheric pressure. That puts stresses on wells, on ageing bits of kit, and it's got far higher strains on the plant. Operating at 30 bcf. Essentially, the pressure in the national transmission system pipeline is higher than the pressure in the reservoir. In order to put gas in the reservoir, what we do is we simply open the tap, and we flow it into the reservoir, so it's operating at far, far lower pressures, which means that some of the concerns that we had over some of the wells, for example, are no longer concerns. Now, this is why we can't just ramp the thing back up to 150 bcf because clearly, physically, the cavern can take 150 bcf, but we want to operate this with a very clear margin for error, safety margin, so we're operating at a far, far lower pressure.

Mark Freshney, Credit Suisse

Thank you, very clear.

Chris O'Shea, Centrica

That was the last question. I'd just like to say thanks again for coming along at such short notice. We will look to have more of these teach-ins. We'll give you a bit more notice in the future as we try to bring to life some of the opportunities that we've got in Centrica.

But just to close off. Obviously, I'm delighted that we've managed to bring the Rough facility back to becoming a storage facility. I'm delighted for consumers in the UK; it

will keep prices down. I'm delighted for the help we can give to the UK because it improves our energy security. It also gives us a clear path on the road to net zero as we develop the UK's hydrogen economy. You can all see, in terms of the UK economy, we need to have more export revenue streams, and Rough, in my view, is a key enabler to allow the UK to return to being a net exporter of energy as we embrace hydrogen because of some of these characteristics. There are only two or three countries in Europe that are able to produce hydrogen at the scale that is required.

I see this as being quite a monumental day. Obviously, this is something that I expect to deliver material value to Centrica over the short and the long term. All in all, I think this is a good day. It's good for consumers, it's good for the country, and it's good for shareholders. It's not often you get to have something that's good for everybody, so this is a very good day. It's been a long time coming, but hopefully, this is the first of many conversations that we'll be having about just how important this asset is to the UK and to our shareholders. Thanks very much, everybody. I hope you have a great weekend.

END OF TRANSCRIPT