

# Centrica Preliminary Results for year ended 31 December 2007

21 February 2008

## Presentation Transcript

**Roger Carr - Chairman**

Well good morning ladies and gentlemen and welcome to the Centrica Results presentation. In a few minutes Nick will provide you with a detailed insight into the financial performance of the company and Sam will then set out our achievements in the context of the market conditions that prevailed in 2007 and the challenges we are going to face in 2008.

Clearly whilst the substantial improvements in operating profit and earnings in 2007 were very pleasing and hard earned, the wind in our sails that delivered an extraordinary first half, turned sharply against us in the second half. With rapidly escalating wholesale prices, eroding the strong margins we had established in the first six months.

Erratic wholesale markets therefore formed the backdrop for market leading price reductions in British Gas in the first half of 2007. And the industry wide increases in the early part of this year.

Nevertheless our competitive position has been strengthened through our pricing strategy, our focus on cost reduction and our close attention to improved customer service which have led us to rebuilding both market share and customer satisfaction. In these circumstances the Board believe it is appropriate for shareholders to benefit from the strong financial performance in the unusual conditions of 2007 by providing a 17% increase in dividend this year.

Whilst wholesale markets and global energy prices remain largely outside our control, I would just like to take a few minutes to emphasise the key areas that are within our grasp and where considerable progress has been made in strengthening our business model.

The core strength of any business is the quality of the management. And under Sam's leadership, I believe we are now assembling a team with the right mix of talent, experience and enthusiasm which is rapidly transforming the underlying health and growth prospects of the business.

The effectiveness of the team is particularly evident in the improvements in customer service in British Gas, our leadership in green energy, the robustness of our Storage business, the resilience of the North American operations and the remarkable growth of British Gas Home Services.

Upstream our ability to secure at sensible price levels, further substantial gas and electricity assets to provide greater balance in our Business Model has been limited. But we have had some success recently which Sam will outline later.

However it remains important to ensure that impatience does not lead to imprudence and we are resolute in our commitment to shareholder value, when assessing the opportunities that are available and balancing those with returns of capital to shareholders. Sam and the team continue to carefully examine innovative ways of balancing the demands of value creation with the need for supply security and this will remain our priority in 2008.

I will now hand over to Nick to for the detail financial results.

## Nick Luff - Group Finance Director

Thank you Roger. morning everybody. Before I get into the results themselves, I would just like to start with the commodity price picture that form the background to these figures and in particular explain the significant difference between the first half and the second half.

As you can see and as you will remember, 2006 was a year of high wholesale prices, wholesale prices were falling quite sharply towards the end of the year and that continued into early 2007, allowing us to expand our downstream margins and deliver the tariff reductions that we put through in March and April. In contrast of course in the second half, wholesale prices were rising again, squeezing our downstream margins, reducing profitability in British Gas Residential and necessitating the retail tariff increases that we put through last month.

So that was the commodity price background, let me turn to the figures themselves. Here are the group numbers and to pick up the highlights for you. Revenue for the Group as a whole was actually slightly down in 2007 against 2006. We had some good growth in revenue in some of the growth businesses, but that was more than offset by lower revenue from BGR, a combination of lower average customer numbers through the year and also lower consumption due to the warmer weather.

However despite that reduction in revenue, operating profit was up substantially to almost £1.95 billion. Obviously the turnaround in BGR was the main factor there, but also some good growth in the other businesses which I will come onto later. That improvement in operating profit flowed through strongly to profit before tax and also to earnings. With earnings further boosted by a reduction in the tax rate as profit shifted from the more highly taxed upstream to the more normally taxed downstream businesses, the tax rate fell.

On a per share basis, earnings were 30.6p an increase of well over 50%. The dividend as Roger said, we've put through a 17% increase. Obviously not as much as the increase in the earnings, reflecting the fact that the exceptional conditions that we saw in the first half of '07 are unlikely to be repeated in 2008.

Turning to the individual business units, and you can immediately see the impact of the turnaround in British Gas Residential, profits under £100 million in 2006, rising to over £570 million in 2007. That works out at a margin of some 8.9% for the year as a whole. However to understand the dynamics of that, you really need to look at the year in two halves. And we have done that for you here with these causal tracks. The top two show the first and second half separately. The bottom one shows the combined full year as a whole. Red bars mean negative variance against the comparable period of the year before, green bars positive variances. And as you can see in the first half of course the dominant factor was the reduction in commodity costs because of those lower wholesale prices. Also notice though that average selling prices in the first half were actually slightly above the average selling price in the first half of '06, despite the tariff reductions. And that was because of the timing of the increases in '06 and the decreases in '07 which came through towards the back end of the first half.

In contrast the second half a very different story. Average selling prices actually seen here to be lower because of the tariff reductions, the commodity cost savings of course no longer there because of the rising commodity prices. Put that together for the year as a whole, the dominant factor obviously the reduction in commodity costs, but all coming from the first half. Sales price is actually roughly averaged out for year over year. And in addition of course we did have cost savings. We delivered the £140 million cost savings that we've talked about, albeit that was offset by an increase in transport and distribution costs, an issue that is facing all suppliers in the industry.

Moving to the upstream, Centrica Energy, their results were broadly flat year over year, but again, to understand the dynamics, you really need to look at the year in two halves, given the impact of moving commodity prices. At the first half of course, saw much lower selling prices for the gas production business as a result we also produced less gas. So profits from gas production are sharply down, albeit offset by a turnaround in the legacy I&C contracts which actually were quite profitable in the first half.

Second half, different story overall an increase in profitability. That was the I&C contracts still made a small, slightly positive contribution compared to '06, but with rising commodity prices we were able to produce more gas, average selling price is comparable to the year before and gas production profits up as a result.

So the year as a whole, looking at the bottom chart. That lower average sales price for gas production in the first half, dominating, offset by the turnaround in the I&C contracts, albeit that has proved to be temporary and those contracts now loss making again.

Turning to the other business units. BGB had a very strong year. Profits up almost 40% to £120 million. Both years do benefit from the historic electricity procurement contract that I referred to at the half year. So both years benefiting from that. But nevertheless the underlying performance still very strong. Customer numbers were up. Gross margin per customer was also up significantly. And just to demonstrate that cost savings in Centrica are not just about BGR, we also had significant improvement in efficiency in BGB. Operating costs as a ratio to gross margin improved from 76% in 2006 to just 72% in 2007.

Storage had a record year, very strong year for Storage. The SBU price for the '06-'07 gas year of course was very high. You will recall at 65 pence which boosted the first half results. It fell to 53 pence for the '07-'08 gas year and indeed is likely to fall further in '08-'09 given the narrowing of summer/winter differentials in the forward curve. Nevertheless this does remain a business that is making very good returns indeed.

British Gas Services had a very strong year, profits up almost 50%. Delivered through a combination of strong growth. Revenue was up 16% and also an improvement in the operating margin which was up from 9% to 12%.

Direct Energy, North America. These numbers may not look quite as you were expecting them. That is because of a technical change we have made. You will recall The Consumer Water Heater Income Fund which we used to use to consolidate in our results, even though we had no economic interest in it. We have now deconsolidated it with effect from December. It is now shown as a discontinued activity. The net effect is negligible because there is an offset in interest, but of course it does affect the reported operating profit numbers for Direct Energy. That aside however, Direct Energy did have a strong year. Results shown here as sterling up some 8%, but that was after some adverse currency movements in local currency. The profit is up over 15%. Within that, just to show you the mix effect. We did have some ups and downs. As we flagged up the half year, the mass markets business has been under more competitive pressure, both in Ontario and in Texas and the result from mass markets was lower than '06. However that was more than offset by an improvement in profitability from the newer businesses. CNI moved into profit for the first time. Services improved its result quite significantly and we had a very strong performance from the upstream and wholesale activity.

And finally on the business units, Europe increase in profit there from £7 million to £17 million. Oxxio, our business in the Netherlands moved into profit for the first time. And SPE where we currently hold a 25.5% stake of course, they also delivered an increased contribution.

So that was profitability. Let me turn to cashflow. You can see the effect of the strong operating performance flowing through into cashflow here. EBITDA up to over £2.5 billion. We also had a strong year in terms of generating cash from working capital. That really reflects the tariff reductions which as we put those through in BGR reduces the debt tied up in that business. That will of course reverse in 2008 to some extent as we have now put tariffs back up again.

Further down, margin calls. There was a big margin call outflow in 2006 which wasn't repeated in 2007 given the pattern of commodity price movements. Interest in tax was significantly down because of the timing of PRT payments, a slightly one off effect. Capital expenditure up to £965 million and I will come back and give you a bit more detail on that later. So net net the overall cash, despite that increased investment in the business, cash inflow of £700 million compared to an outflow in 2006 and we finished the year with net debt at under £800 million.

Here is the detail on the Capex I have just mentioned. Obviously significant investment going into the upstream assets. The most significant single item is actually the Newfield acquisition down at the bottom there, £242 million investment. But also we continue to invest in our existing fields. We put over £100 million into developing our existing gas assets, mainly in the North Sea of course. And on the power side, some significant investment is going on there on the conventional, the new Langage gas fired power station down in Devon we continue to invest in. And on the wind side, we have got the two wind farms at Lynn and Inner Dowsing which are absorbing significant capital as well.

Finally for me, a few items that we have had the opportunity to simplify in the structure in 2007, tidying up the balance sheet. First The Consumer Water Heater Income Fund, which I mentioned earlier. If you recall that income fund was set up in 2002 as a vehicle for financing water heaters following the Enbridge Services acquisition in Canada. The relationship between us and the fund was one where we effectively controlled it and hence we had it consolidated in our accounts. That has been changing over time. It is now a more normal contractual relationship, rather than a parent subsidiary relationship. Hence no longer appropriate to consolidate it. So we have taken out the figures with effect from December, showing it discontinued in 2007. But the net effect on our earnings as I said earlier is negligible, however it does take close to £600 million of debt off the balance sheet albeit we did use to classify that debt as non recourse and quite rightly most people tended to ignore it when looking at our figures.

The Humber finance lease, we flagged up in December that we terminated that early. We have taken a charge of £40 million within the interest line for doing that. It does simplify the debt structure quite considerably and gives us some ongoing benefits so we thought that was worthwhile.

And finally a new one, something we have done since year end although we have taken the charge for it in the year end numbers. If you reach note 35 of last year's annual report and accounts you will have noticed that we had an ongoing discussion with the Revenue about some technical issues on upstream taxation. I am pleased to say we have now settled those with the Revenue. The settlement doesn't actually involve us paying any additional tax, but what it does do is move some profits forward from more recent years to earlier years. There is an interest cost attached to that and we have taken a charge for that in the 2007 figures as shown here. So all in all those items cost us about a penny per share off the EPS in 2007 but nevertheless we thought that was a cost worth bearing in order to tidy up and simplify matters.

In summary a strong financial year for Centrica as a whole, albeit very much a year of two halves with the very strong performance in British Gas Residential in the first half, rising commodity prices, meaning margins are squeezed in the second half. And on the cash side a very strong year for cash generation, leaving us in a very strong balance sheet position as we look for the upstream assets to improve the vertical hedge.

And with that I will hand you over to Sam.

## **Chief Executive's Review**

### **Sam Laidlaw - Chief Executive**

Thank you very much, Nick. Good morning, everyone. It may be a cliché but as Nick has just told you, 2007 really was a year of two halves. The key driver of these short term results was the positive impact on British Gas of a sharply falling wholesale gas price in the first half of the year and clearly this turned around dramatically in the second half. Nick has taken you through the detail, but I want to concentrate on some of the progress that we are making against the longer term priorities that I set out 12 months ago. I think addressing these will enable us to deliver both growth and more robust earnings well into the future. Let me remind you of these priorities and then I will give you my perspective on the progress we have made and where we go from here.

First to transform British Gas, second to sharpen the organisation and reduce costs. Third to reduce risk through increased integration. And fourth to build on our growth platforms.

Let's look at the transformation of British Gas. 2007 has been a really big year for British Gas in every way. It has undergone some major change under Phil's leadership. I talked a little bit about this at the half year results and gave you some early indications, but the story has moved on a long way since then. You will remember early in 2007 we repositioned British Gas and closed the tariff gap with our competition. Whilst price competitiveness is something that we will maintain since then the drive has all been on customer service. And as you can see from this slide, we have made great strides. We will not be fully satisfied until we are back at the top of the tree, but the progress here I think is significant. We are answering the phones faster. A 75% improvement from our worst position back in April. Based on this we have been reducing the number of customers who don't get through. On average this down by over 70%. Improving customer satisfaction and of course removing repeat calls. We are also answering correspondence faster. We have eliminated all of our correspondence backlog, and by the end of 2007 we're replying to 90% of emails within 48 hours. And all this is translating into an important, but lagging indicator of lower complaints. The level of complaints to energywatch has fallen by over 80% since the high watermark in April. We are not at the end point yet. But I think even the result in December still represents too high a level of total industry complaint levels. But we are definitely on the right track. And customers have been coming back. Through to end of 2007 we saw nine consecutive months of customer growth with churn falling and record sales levels across the year. We also redesigned and improved our online offering and we now have just over 900,000 self service customers who manage their accounts online and this number continues to grow. And we ended the year with a few thousand more customer than we began.

So I think, while delivering substantial service improvements, the other dimension is that we also made a significant improvement in our operating cost base. We delivered on our promise at the half year to remove £140 million from the operating cost base in British Gas and that is a year on year cost reduction of some 15%. Although this is less than the £200 million we originally planned, we consciously decided to prioritise service in 2007 as we told you in August add further cost savings are coming out this year when we will deliver the full balance of the £60 million.

In our second priority, we are seeking to drive a greater sense of efficiency and cost consciousness right through the wider organisation, the whole group, working smarter and cheaper with clearer accountabilities and this is something we are really drilling into the DNA of the organisation. We fundamentally restructured important parts of the organisation. We split British Gas Residential into three P&Ls to address the different customer requirements and to unlock value. Our new Pay-as-you-go segment, better addresses the needs of those customers who use a pre-payment meter. The rest of the British Gas customers have been segmented between the lower burn customers and those who would be considered the most valuable.

We have also restructured Direct Energy from its previous geographic focus to a "line of business" functional model. This mirrors the UK and will maximise the growth opportunities right across North America. And as you know, we now report the results from our Power Generation assets separately.

On our people agenda, the skills review we carried out in the early part of the year, enabled us to slim down the top management layer and we reduced this by about a third and have filled some important gaps in capability over the last 12 months. Overall in 2007, we also reduced our total headcount in the base businesses by over 2,000 roles. And in 2008, while we will see an increase in costs in our expanding businesses, we expect those increases in cost to be fully offset by further substantial cost savings across the Group.

But this is not just a cost story. In order to make sure that we are maximising value, we are tracking a series of metrics closely. Here I have presented a selection of metrics. These ultimately really fall into three categories. Those that focus on cost efficiency, those that focus on growth potential and those on return on capital. Some are more appropriate than others for different parts of our business. And this is by no means an exhaustive list. For example, customer numbers are important, but it is really the value of the customer base rather than

the absolute number that matters. There will also clearly be trade-offs among some of these and we will take decisions to maximise long term value. Let me give you an example. In British Gas Services. The ultimate goal of operating profit growth will sometimes come through top line growth and sometimes through margin expansion. And in Direct Energy we will need to balance growth with operating efficiencies, while driving a return on capital above the Group Weighted Average Cost of Capital. By focusing on and optimising these metrics, we will ensure at all times that Centrica is focusing and performing to its full potential.

I would now like to turn to our third priority to reduce risks through increased integration. On power we have been making some solid progress. You can see from this map, how we are moving forward. We are building on our position as the major energy supplier with the lowest carbon intensity generation fleet. As you know we acquired half of the equity of the Braes of Doune wind farm in October last year. We also have three major Power assets under construction. The 885 megawatt CCGT plant at Langage in Devon and this will be the cleanest and most efficient of its type in the UK. This project is on budget and scheduled to start up early next year. And the wind farms at Lynn and Inner Dowsing, 180 megawatts in total of renewable energy. This will take our total in the UK including joint venture assets to almost 370 megawatts. These wind farms are on schedule and on budget and will be operational later this year.

And we have several projects on the drawing board. There is the potential for a further 1.25 Gigawatts of wind energy off the Lincolnshire coast and the first 250 megawatts of this in late stage planning. We also have an opportunity to expand our footprint with additional gas fired generation next to our current gas-fired plant at Kings Lynn. So there is a lot going on in UK power and these investments strengthen our earnings and reduce the risk profile of our business.

Here you can see the build out of just the current assets under construction, including our contract with Drax and our portfolio, wind PPAs, we will cover around 90% of our peak residential demand by our own power assets by 2009.

Let's turn to gas. In gas the story is also promising. Although we have not yet acquired assets of a size that can really make a one off step change in the business, we have been creating some very promising positions. Here I have laid out what we have added recently. Through the Newfield deal at the end of last year, we gained a producing gas field and two undeveloped fields. After some very promising production rates from the producing Grove Field, we added to the equity positions with our Sojitz deal last week. We were also successful in the Norwegian licensing round two weeks ago which brings a further six exploration licences bringing our total in the North Sea to 19. We expect this year to begin further development of the Grove Field to progress the development of the Seven Seas Field in the Southern Gas Basin and production commenced from the Maria field a few weeks ago. We will also begin drilling on at least one of the Norwegian exploration prospects this year. Further afield, we will very soon commence seismic on one of the blocks in Nigeria and our MOU with Statoil and CCC gives us a very credible partnership to develop an LNG facility. The acreage in Trinidad and Egypt also offers longer term potential in LNG with our additional capacity at Isle of Grain now enabling us to import almost 6 billion cubic meters of gas into the UK each year from 2010 onwards.

We have much to do in this area but even the small steps we have taken in 2007 have had a positive impact on our short term gas hedge.

Looking out to 2011 you will see that just including the planned development of our current North Sea equity positions we managed to gradually increase our hedge ratio. The depletion of our more mature fields is offset by the increasing production in our newer fields, and the further development of some of the newer prospects. If we were to layer on just a conservative acquisition assumption of some 100 billion cubic feet per annum, we can grow this percentage in this timeframe to almost 35%.

Now of course building out these power, gas and possibly additional storage positions will require a material amount of capital spend. Looking at 2008 therefore, before we allocate any capital to additional acquisitions, we currently anticipate spending around £850 million. Of this £600 million will be spent in developing the current portfolio of opportunities, including completing the major power construction projects in the UK. On top of this between Sojitz and Rockyview, we have already spent £93 million so far this year on new gas

acquisitions, and as you saw from Nick's presentation, we have substantial head room for further acquisitions. But as Roger said, we will not let impatience lead to imprudence. And it is not possible to predict which of the opportunities that we are currently assessing will eventually materialise for value. Success here will make our forward earnings stream more robust. But we also need to grow it.

And that really brings me to our fourth priority, building on our growth platforms. You will see here that we have a strong track record of growing these businesses. Since 2004, across British Gas Business, British Gas Services, North America and Europe, we have now grown our total customer relationships by 17% and actually have as many customer relationships in these growth businesses as we do in British Gas Residential. In 2007 they contributed almost a quarter of the Group operating profit.

Now I would like to take you through each of the growth platforms in turn and look at the size of the opportunity and why I believe we are in the best position to capture it. In British Gas Business we are at the heart of a £20 billion energy market in the UK. Our share today is only 12%. On top of this the commercial services market is almost untapped and there is a large amount of value to be created from raising the average product holding across our customer base and continuing to increase the average customer size. Under the British Gas brand we are one of only a few suppliers who serve the entire commercial sector. Our services proposition is differentiated and is tiered to provide appropriate support for our customers. We are preparing for the long term by taking a leadership position in rolling out smart meter technology and we have already installed some 25,000 smart meters. And our track record here is strong. Over the last three years we have grown our volumes by 24% and in 2007 we delivered an operating profit of £120 million. That is up 38%. The market remains very competitive, but we are very well positioned with the brand, the organisation, the processes and the propositions to capture the opportunity.

In British Gas Services, we laid out the size of the opportunity for those of you who were able to come to our presentation early in 2007. This is a market worth some £6 billion in the UK and it is growing rapidly, especially in the newer product areas where we are increasingly strong. Once again the brand is a key differentiator. We also have a truly national footprint supported by the highly skilled engineering workforce of some 9,000 engineers using leading edge deployment technology to maximise efficiency. And we have a large customer base which enables effective cross selling of what is now a very broad range of home services products. And our recent profit growth here has been exceptional up by 50% in 2007. This business can continue to grow its bottom line very rapidly, particularly as we start to roll out a wide range of energy efficiency products and services.

In Direct Energy, the North American energy and services market attracts revenue of some 500 billion dollars a year, even though many states have not yet deregulated. In the US C&I space, over a thousand terawatt hours of power load is open to switching and less than half of that has switched to date. Of this we serve around 14 terawatt hours. A great start, but clearly a lot of room to grow. And the mid stream and wholesale arena presents another real opportunity for us. In 2007 our mass market business did suffer from two unique events. The expiry of the original five year electricity contracts in Ontario and margin compression in Texas, following the takeover of TXU. Despite this, strong performances by our C&I business, Services and Wholesale businesses proved the robustness of the model in very volatile conditions. And we have a proven track record of continuous growth over almost eight years. And 2007 produced another record year of operating profit. We are successfully developing material revenue streams outside the mass markets energy business in North America. Our C&I business here posted double digit top line growth and moved into profit for the first time and our upstream and midstream business is becoming material, delivering over 25% of the operating profit in 2007. Our Rockyview upstream acquisition will increase our Canadian production by around 20% this year. And our North American Services Business continues to grow and is well positioned to offer a whole range of energy efficiency products to customers who are increasingly economy conscious and climate change aware.

That really brings me to British Gas New Energy. Working in conjunction with British Gas Residential and British Gas Services, this is our UK response to the growing awareness among customers in the UK of the impact of climate change and the increasing desire to lessen this impact through energy efficiency measures. For example recent research suggests that the microgeneration market over the next 10-15 years will be worth

some £3 billion with the demand for more than 10 million units. British Gas is the most trusted brand and the largest installer of new energy technology through our nationwide engineer workforce, training centres and support infrastructure. To date we have launched two industry leading green energy products through British Gas Residential. We remain the largest investor in the Government's EEC programme and its successor the CERT programme. We are discharging our commitment, not only through conventional insulation and efficiency solutions, but also with new technologies, such as our investment in Ceres last month which keeps us at the forefront of fuel sell and microgeneration technology for domestic use.

So I think in summary, financially 2007 was a very strong year. But it was also an unusual one. Behind the financial results we have set very clear direction for this business which will provide a sound platform for sustained growth. We have made substantial progress against the priorities which we laid out in February, but further vertical integration remains the key to turning this into an even better business. And while we won't let up on any of the priorities, this will be the centre stage in 2008 and beyond.

Although the wholesale commodity outlook does remain challenging and provides a head wind for our business, our defence will be the single minded focus on executing efficiently and creatively against each of the strategic priorities.

Thank you.

## **Roger Carr**

Thank you very much Sam. We will do some questions now. We have got a full team here as usual. Derek King from North America, Phil Bentley, the increasingly famous face of British Gas. Jake Ulrich who looks after our upstream activity, Chris Weston who has driven the remarkable growth this year in BGS and we also have Grant Dawson who is our Chief Legal Counsel. But importantly he is the man who looks after the Rough Storage operation. Finally, Mary Francis is here, our Senior Independent Director, who will not be answering questions, but will be marking us all out of ten. So with that, any questions please.

## **Questions and Answers**

### **Bobby Chada, Morgan Stanley**

I just wanted to turn back to those slides you showed about increasing the upstream integration. So in power you will be sort of close to 90% in 2008 sorry, 2009. Have you got a new target for that? And in gas you showed that you would be close to 35% equity gas hedged by 2010/11. Where would you ideally like to take that to? And just as a follow up, in previous meetings you have talked extensively about the options for large deals with national oil companies. I notice that you didn't mention that today. Can you give some update on any progress on how the discussions have gone and whether that is still something you still are interested in?

### **Sam Laidlaw**

Thank you Bobby, two questions there. Let me deal with the first one. What is our targets for the structural hedge long term? What we have said and we primarily clearly have the shortage, as the slides indicate, on gas rather than power. But we can see power as a proxy hedge for gas given the strong correlation between the two prices in an economic sense. What we have said is that we would over a five year target, which we set out a year ago, aim to close that structural hedge to 50%, of which half would come through assets and approximately half through different forms of contracting. Now if we can take the risk out of the business by doing more with assets, more economically, for better value and less with contracting, we will go down that route. Equally if we see better opportunities with the contracting route rather than putting the assets on our balance sheet, then we have some flexibility to do more of that. I think what the slide, so that would imply that on gas we would need to get to the 35% if we just did it 50-50. I think it would be very much dependent on the opportunities and as I say we may use power as a proxy hedge for gas.

The second question dealing with our discussions with national oil companies. We continue to have discussions with national oil companies. I indicated I think at the last presentation that it is in the nature of these discussions and the counterparties that we are dealing with, that they do take some time to put together. Obviously the UK market early last year became in the eyes of some sort of short term commentators, a less attractive market to sell into, particularly in contrast to some of the Asian markets. What we have seen in the last six months with the rebound in wholesale prices in the UK and the fact that UK prices are now at a significant premium to Henry Hub prices, that actually many of those national oil companies are increasingly interested in selling in the UK markets. So those discussions continue. But as I have indicated before, they do take time to put together because these are typically 10-20 year contracts and the terms need to be right.

### **Simon Edrich, ING**

Question not captured

### **Sam Laidlaw**

Let me deal first with the margin target question. What we have consistently said is that we believe that this business on a through-cycle, sustainable basis, should have a 5% return for the industry average and with the cost savings and economies of scale that we expect to get and with the brand premium that we expect to have, our target is a 6-7% through-cycle margin. Now clearly we did a bit better than that last year. We are managing this through-cycle and we are not going to get into forecasting short term, particularly with the sort of volatility of the commodity market at the moment. But that is our through-cycle aim.

The second question was around Capex and spend. As you can see from the slides we have a big programme of organic capital, but we also have head room and last year we spent some £250 million on acquisitions. We have spent £93 million so far this year. We expect to do further acquisitions if we can find value. They may be bolt-ons, or they may be larger opportunities. We don't comment on specific things that we may be looking at. I would say that the Distrigaz situation really is an opportunity for SPE, in which we are a 25% shareholder not the controlling entity. So it is for the SPE Board and all the investors to decide where that goes.

### **Jamie Tunnicliffe, ANB Amro**

Just two questions. Firstly I was interested about the comment about seeking differentially indexed contracts in terms of I think gas supply. I would appreciate it if you could expand in terms of the sort of appetite and the forms that that might take. And then the second one is I suppose, you mention yourself about the very high oil prices we are seeing. I think you say that index-linked gas prices from the continent seem to be taking the lead in the UK. So you know, does that lead you down then to thinking more about I suppose the proxy forms of gas hedge that you have talked about and being creative rather than the straight gas hedge? Or is there a way around that as well in terms of the physical asset? Thank you.

### **Sam Laidlaw**

Two parts to the question really, one is differentially-indexed gas. By that we really mean. At the moment a lot of our gas is purchased on month ahead prices. If we can get some on day ahead, some on different indices, and they may have other oil components, other energy components or CPI components, then clearly we take some of the volatility out of the overall basket. And I think we also probably put our procurement on a more comparable basis than some of our competitors. So I think that is the first piece.

The second question was around contracts in Europe, index contracts in Europe. How do we think they are impacting the UK market? I think the reality is that with the very strong run up that we had in oil prices at the end of last year, and the fact that there is a six month lag before that translates into the gas pricing formula of continental contracts, that has prevented a lot of gas coming out of storage from Europe into the UK, despite the high UK prices. And that is one of the reasons I think why we have gas prices where they are. Would a proxy hedge be a good way of addressing that? It certainly, it is all about value at the end of the day, whether there are better opportunities in power or in gas. But there is a strong correlation between the two.

## **Colin Pollock - CSFB**

Question not captured

## **Roger Carr**

Why don't I pick up the return of capital point? I mean clearly you know as a policy, this is a model which is pretty much geared to shareholder value. We have been very clear on that. And you know indeed the dividend move is a reflection of that in the short term. I think we have also been clear that you know we have a plan which is to build up the hedge of this business which will need investment both in the development of assets and the acquisition of assets and I think in order to make the model sustainable on a long term value creative basis, that is where we must keep our priority. However, where we have surplus capital, and it is surplus, then we will revisit the return of such capital to shareholders. But it is in that priority and it is important that everyone understands where our focus is, but also understands it is underpinned by shareholder value as the key.

## **Sam Laidlaw**

The second question was around the operating cost metrics and whether that includes depreciation and whether there is a long term target I think and whether there is a long term target?

## **Nick Luff:**

Yes it does include depreciation relevant to British Gas. The £800 million of operating costs in 2007 has got about £40 million of depreciation in it. As regards a target, we are not setting specific targets externally for each of the metrics we have published. As Sam said in his presentation there is a trade off between some of these measures in any one given period. So our objective is clearly to exploit the economies of scale that we have clearly got compared to other suppliers and to be the most cost competitive in terms of the operating costs per customer but we don't have a specific number that we put on it externally.

## **Sam Laidlaw**

In answer to your last question Colin which was about customer churn since the price increase. The answer is simply that it is too early to tell definitively but what we can say is we added customers in January. When we look at the move, call volumes in our call centres have actually been down significantly relative to previous moves. We think a number of customers are waiting to see. But also I think the improvement in our service levels has meant that we have been able to get back to customers much better. ASA's are down 80%, abandoned calls. And therefore this price change I think was much better operationalised than previously. And some of that is the benefit of the new SAP systems as well. And sales are still holding up strongly. So I think it is too early to tell. Because of the 28 day notification period we won't really know for another couple of weeks. But so far the signs are encouraging.

## **Edmund Reid, Cazenove:**

Three questions? The first one was on your comment regarding using power generation I guess as a kind of dirty hedge for gas. I assume you mean non-gas fired power generation? And when we are looking at the UK, I guess we are looking at sort of three types, coal, nuclear and wind or renewables. And I just wondered if you could talk about your views on those three? The second one was in terms of the I&C contracts, if you could give any guidance for 2008 where you would expect those to be? And then the third question, I understand that you don't want to get drawn on margins, but when you look at your current retail price and where the wholesale curve is for the year, where would you think, if those things stayed the same – ceteris paribus - what the margins would be?

## **Sam Laidlaw**

Well I think we can deal with the last one first by saying, it is a good try, but we are not going to speak to it.

Obviously it is competitively sensitive information as well. But let me come back to the first one and I will let Nick deal with the I&C guidance. Clearly, you are absolutely right. If we want a proxy hedge for gas it has to be non-gas power and that as you rightly say leaves us with coal, included in that clean coal, wind or nuclear. And we look at all of them. Clearly the low carbon footprint that we have from our existing suite of assets and a view that we have about increasing carbon prices over time. Unless we can find clean coal economically or unless we can see coal assets that have the opportunity for reducing their emissions over time, makes that structurally a bit more of a challenge. New nuclear is going to take time, wind is clearly something that is already under construction and we will do more of. But at the end of the day, it is a balance of value and the determinants of value are obviously construction cost, carbon price and reliability. And we look at all those dimensions. But we are not ruling any of them emphatically out.

### **Nick Luff**

On the I&C contracts, we have about two billion therms going through those I&C contracts. The prices are linked to various things other than gas so we will, depending on where oil for example comes out, we might get a small increase in the selling price in 2008 but if you think that the input price has probably moved 15-20 pence, based on current forward curves, then you can do the maths. It is quite a swing from the £180 odd million of profit we made in 2007. You can do the maths of the sort of impact and where they could end up, at least on current forward prices, albeit of course, gas production profitability is up significantly in the same environment.

### **John Musk, Lehman Brothers**

Two questions. Firstly on the upstream business. Production levels in 2007 were up on 2006. What should we be looking at for 2008 and what sort of capacity have you got to run existing fields harder? And then secondly on the average consumption levels in the supply business, they are obviously down year on year and we have been seeing a declining trend. How much of that is weather and how much of that do you think is actually energy efficiency? And what are you yourselves modelling in for long term trends in gas and electricity demand?

### **Sam Laidlaw**

Let me deal with the upstream one first. Recognising the investments we have made with Newfield, we actually expect to have an increase in gas production next year. And I think you can assume something in the order of 10%. Now, much will depend at the end of the day on the shape of the curve and how much we run Morecambe. And which really is your supplementary question, what is the additional capacity there? Even last year when we were running in the second half of the year, Morecambe pretty actively, we were not by any means close to the deliverability of Morecambe so there is quite a bit of additional head room there were we to wish to run Morecambe because we had extraordinarily high prices for a sustained period of time. So we are not, if you were to add 10% to last year's number you would still be some distance short of deliverability.

The second piece I think was around consumption and what has happened to consumption patterns. You will see in British Gas Residential, demand for gas was down by 11% but perhaps more relevant, demand per customer is down about 5%. We think that the overwhelming majority of that was due to the unusually warm weather that we had at the beginning of the year. But there is no doubt that behaviour is starting to change. People are adjusting their thermostats and we have our own programmes to encourage energy efficiency. So it is not surprising that some of that is coming through. My guess is that probably of the per customer number, 75% of it is weather, at least and maybe 20% of it is change in behaviour. number, 75% of it is weather, at least and maybe 20% of it is change in behaviour.

### **James Hutton-Mills, UBS O'Connor**

Hi. Good morning. Could you talk about the trade off strategically between sustaining your margins and growing your customer base in this very robust energy complex environment? i.e, I suppose I am a little bit surprised that you are not being more aggressive on cost cutting for this coming year. Can we assume from that that maybe you might want to let some customers go, going forward, if prices remain as high as they are?

### **Sam Laidlaw**

Thank you James, the question is around the trade-off between returns and customer, short term returns and long term customer numbers. I mean obviously I think what we have signalled is that actually with our SAP system and the segmentation of our customer base, we now have much better management information on who our valuable customers are and this is going to be about value rather than just absolute customer numbers. We recognise that there are a percentage of very low volume customers who may be switching a lot who probably have less value to us than some of the dual fuel direct debit customers. So we will be managing for that. Which is why I said in my remarks, although we look at customer numbers, and they are important, and obviously we want to keep as many customers as we can. This is long term value that essentially we will be optimising.

### **Further question**

Just staying on the cost cutting issue, can you, How do you give us more confidence that you can sustain margins without being more aggressive on cost cutting going forward?

### **Sam Laidlaw:**

I think the answer is we are aggressive on cost cutting. The £60 million that we will take out of Residential means that we will reduce the cost base of that business by 20% over two years. And we will continue to keep our foot to the floor. We have a number of other initiatives group wide. What I also said in my remarks was that actually, although you have obvious inflationary pressures and you have clear pressures on increasing operating expense in our growth businesses, such as the Services businesses where we are adding engineers and Direct Energy where we are adding customers. Overall we expect to keep Group operating expense flat, although we are, at a Group level, adding customers. So you know this is I think something that we will stay very focused on.

### **Chris Rogers, JP Morgan**

I notice from your slide of '08 CapEx, you have a projection for costs of ROCs and for CO2 emissions, could you perhaps split that for us? And also give a bit of guidance about where it is going to go because clearly CO2 prices will probably increase over time, your allocations may reduce over time. And similarly your renewable obligation will increase over time. So are we talking plus £50 million a year or what kind of level? And related to that, do you have a view on what kind of level of ROC hedge if you like you would aim for? I mean obviously it is tied up with how much wind you are going to build. But perhaps where you are at the moment in terms of hedge and where you would like to be? Thank you.

### **Nick Luff:**

On the split of ROCs and emissions, obviously emission allowances costs in 2007 were virtually nil. And that is what is driving the big increase in the figure. So we are budgeting around £100 million. Clearly it depends how much ultimately our power stations run, which depends on spark spreads, but in that number there is around £100 million. The rest is for the ROCs.

### **Bobby Chada - Morgan Stanley**

Just a couple of follow ups. On power plants they had very, very good first half and not a bad second half in terms of load factor. What are you budgeting for the production division in terms of load factor going forward from here? And secondly could you outline the value proposition you see in the Ceres tie up, the contract and the stake you have taken in the company?

### **Sam Laidlaw**

I mean I think the answer is we certainly expect to do significantly better obviously than the second half with our assets going forward and one of the advantages of having separated this out is I think we have much better visibility on it than we had in the past. In the second half of the year we did have some unfortunate

unplanned outages in Killingholme and Spalding at a time when the spark spreads were particularly good and then of course we had to buy the power back in the market. We don't obviously expect that to be repeated. And actually if you look at the forward spark spreads today, they are better than they were this time last year. And we are looking first half, £12 '08 compared to you know first half last year significantly lower. So we think that that business will perform much better this year than last year and certainly that is our internal target.

Second part was around Ceres. Our relationship with Ceres, and we have been talking to them for a long time. We are obviously the natural installer of this technology. It is a low temperature fuel cell which they have designed to a size now that can be installed in a conventional wall-mounted boiler. And has obviously the opportunity of not only generating heat and hot water, but also generating electricity which could be sold back to the grid. So we think it has very exciting application which will lower the carbon footprint of homes. The relationship we have is an equity investment which obviously helps them get through the development stage. The technology works. The question is, can they get it to a cost that is going to be attractive to install? And our funding helps them, through the equity investment, to achieve that, but also gives us exclusive rights for the first four years on the product. And that is critical. We wouldn't just make a passive investment in a new technology. It has to be a technology that we can use and we actually have exclusivity and rights on it.

### **Andrew Mead, Goldman Sachs**

Can I just ask, on your performance metrics, just on one of them, the upstream return on capital employed. Is that something we should focus on or look at? Because in terms of looking at the number, clearly it is obviously helped I guess by Morecambe at the moment and as you change the mix that will change? And also in terms of looking at the capital you are looking to deploy into that business going forwards in terms of this. Is the number good or bad?

### **Sam Laidlaw**

I think this is something we will be looking at very closely. And therefore I think you should as well. It is a fairly typical measure for integrated energy companies. It is obvious that as you rightly say, Morecambe which has a low capital, historic low capital base, has very high returns. Our recent gas acquisitions have pretty good returns. The power stations, if you look at the results of the second six months of 2007, are obviously poor returns. This helps everybody get focused on the issues. I think it is an important measure.

### **Iain Turner, Deutsche Bank**

If I can ask about the North American business. I know Deryk's come a long way, it is worth asking him a question! Just a bit more colour on what has been happening in Ontario and Texas and the upstream segment in 2007 and how you see that rolling forward into 2008 please?

### **Deryk King**

Well thanks for asking a question about North America, I do appreciate it. I have come a long way. I think both Ontario and Texas we did suffer from one off incidents in 2007 and in Ontario that big tranche of electricity contracts that we signed up at the market opening in 2002 as Sam said, rolled off. They were five year contracts and we had to renew them one by one. Some of those customers did renew with us. Some renewed with other suppliers. There are obviously a large range of other products being offered in the market now. We turned the corner in the third quarter and started to grow our business again in terms of sales less churn and those numbers began to come through in November in terms of customers on flow. So that business, our Canadian residential and energy business is now growing again.

In Texas I think we have always said, or I have always said that I would expect margins to come down from the extraordinarily high levels that we have seen in the past to more reasonable levels. And that is indeed happening. But what the unexpected development in 2007 was the acquisition of TXU by a private equity consortium. And as part of the regulatory compromise to get that deal through, TXU agreed to reduce its retail prices by 15%. That left some of our price contracts out of market and we suffered increase in churn and

as a consequence an increase in bad debt. And then we have had to make some, what I would term surgical reductions in our prices to meet that competitive threat. I think we have now stabilised the situation in Texas and we need to start growing that business again.

### **Sachin Oza - M&G**

I just had a question on the vertical integration issue and if I could just summarise what I think has been said. Progress hadn't been made at the same extent in 2007 as one may have hoped. It is top of the agenda for 2008. And then you kindly gave us a list of ways in which you could get there. National oil companies. And then the vertical hedge in power generation. As you talked about national oil companies, new nuclear renewables and coal. None of them seemed like issues that would be available to solve a vertical integration in a step change next year, the year after or even longer than that. So I am just curious in trying to tie up what you said about it being top of the agenda and the actual opportunities you have talked about being available to achieve it. So that would be helpful. Thank you.

### **Sam Laidlaw**

It is a good question which is around the timing of the opportunities and when they can contribute to closing the structural hedge. Clearly the ones that can close it quickest are the gas assets. And acquiring more gas assets like the Newfield acquisition we did last year. And you know we expect there will be opportunities to do that. But it is also a balance of building longer term positions over time where LNG plays a role and where obviously the wind programme on power plays a role. And new nuclear will play a role. So I think what we are looking to do here is close out this structural hedge over a period of time and that is going to take capital. Some of it organic capital, developing the existing gas and power assets and some of it acquisition capital. But it is our top priority, you are absolutely right Sachin.

### **Peter Atherton - Citigroup**

Just back to the slide 27, the reduced risk through integration slide. Just on the green section, the development section which plays quite an important role over the next 2-3 years. Can you take us through the risks associated with that green slice not being quite as contributory as it appears?

### **Sam Laidlaw**

The development piece is really a function of a development drilling programme that we will have on Grove this year. We also have Seven Seas. We had some opportunities around Morecambe. You know we think obviously as you get further out, that has an exploitation risk associated with it. But actually over the next 2 or 3 years that is reasonably robust. So we haven't put anything in here for what I would call wild cat exploration because the reality is that if we were to make a Norwegian discovery in 2008, we wouldn't be able to bring it on stream within this time period.

### **Further question**

Second question is, when you did your seminar on British Gas Services earlier, about a year ago, roughly I think, one of the things that stood out was the lack of cross selling between energy and home services. You gave us some numbers on that and you were hoping that would improve greatly in the coming months, particularly as the improvement in Energy's customer service levels proved. Have you seen that? Could you give us any sense of how you are progressing?

### **Sam Laidlaw**

Well I think it remains a big opportunity. We are only just starting really to bundle the two products together and find out which propositions have the most appeal. And Phil I don't know whether you would like to speak to that or Chris would like to speak to it?

### **Phil Bentley**

Yes I think we all recognise it is a big opportunity there and if you look at our high value premium customers,

750,000 of Chris' best customers for taking service products don't take energy from us today and that is an area we are very much targeting to attack. We have got a couple of new products up our sleeve that Chris and I are working on together which will really target the opportunity for cross-sells such that if you are not a British Gas Energy customer you will not get the same level and opportunity to take the particular service offer. So we are quite optimistic about the opportunity there. I do agree with you though there is some real value that we are probably leaving on the table today that we absolutely want to get after this year.

#### **Further question:**

Just on your metrics sort of performance of customer service over the last few months on slide 19, it looks very impressive but could you give us a feel for where you now stand relative to best in class?

#### **Phil Bentley**

I think we have made some good progress and that has been done by a lot of hard work to just fix the basics frankly. As you know, we put in a system that has had its challenges and I think the good news is it is a lot more stable now and we are able to start exploiting it in the way that Sam mentioned. We can exploit it in terms of ability to move quickly to reprice. We can exploit it in terms of slightly differential pricing in different segments and it just gives us a far more sophisticated pricing module. On top of that it has given us much better MI, Management Information that really helps us see through end to end exactly what processes are driving what costs. And one area of real focus in 2007 is repeat calls. One of the key targets we are setting on agents. We used to measure agents performance with a sort of Chinese menu of about 25 different things and we had a whole army of people measuring performance. We are simply now trying to say, repeats is a big issue for us and we want to drive repeats down. Now in terms of measures, the latest data that has come out indicates that we are no longer bottom of the league in terms of customer service from the latest energywatch complaints, which is good news. And equally on sales complaints, we are between 3rd and 4th now in the industry. So I think we are making progress but as Sam said, we still have quite a long way to go and that is why I think we are confident about our ability to deliver the Opex targets in 2008.

#### **Richard Alderman, Merrill Lynch**

Two questions. Just to clarify on the upstream asset opportunities for purchases. If a coal station came on the market, would you give it serious consideration as an acquisition opportunity? Or would an old coal station dampen your clean mix too much? And then secondly, a question for Phil. What percentage of your 7% increase in sales last year was from online customers, Click Energy? And have you seen a material change in that in 2008 since announcing the price increases?

#### **Sam Laidlaw**

Let me deal with the coal question first. I think it is very similar to a question that was asked earlier, but to be clear. Yes obviously it would impact our low carbon credentials, but if we think, and if it is a very old coal station that is shortly going to be retired, I can't see the opportunity if it is one of the large combustion plant directive closures. But if it is a station where actually we think that there is the opportunity for CO2 capture and CO2 sequestration and we could actually convince ourselves that the economics worked, then we would look at it. So it has got a hurdle to overcome, but it is not out of the question.

#### **Phil Bentley**

Just to be clear. I think one of the benefits again of the new P&Ls is that we can allocate sales activity and manage the channels for value. We have some channels of some sales activity that has very high churn and actually probably destroys value. And we are materially shifting the way we are allocating resources to sales channels in 2008. Specifically therefore we would expect to see growth in higher value customers in 2008. Click actually is very much a niche, it is a niche offer. It is a small number of customers that are on it and therefore financially adjusting the price doesn't have a really big impact today. We use it very much as a fighting offer. Fighting brand.

**Further question:**

Am I correct in assuming that you haven't put prices up in 2008 on your online service yet? And do you plan to soon?

**Phil**

Well we have put prices up on Click, we did it a week last Friday.

**Roger Carr**

That is about ten to eleven, unless there is any pressing point, I think we should wind it up and let me just thank you very much for coming this morning. Thank you.

End of Presentation