

CENTRICA - preliminary results 2002

Core energy business

Q.

Performance in your core energy business has improved. But on the back of the gas price rises that you announced last February some might have been looking for a stronger profit performance. So are these numbers as good as they look?

A.

We think they are pretty good. The profit in the downstream business is £218m, which compares with £19m last year. We're investing at this time in a lot of new systems. We're also incurring quite a lot of energy efficiency costs to the company. And on top of that it was quite a warm year, as you recall, and therefore consumption was down. So overall, we're quite pleased with these results.

Q.

The operating margin in energy supply is around 4 per cent. Does that indicate that earnings are being held back as you work to grow the electricity supply side of the business?

A.

In the year we added about 400,000 customers in electricity. So obviously we have to pay for the cost of acquiring those customers, putting them on supply. We're quite pleased with the progress we're making in electricity now. We have 22 per cent market share on top of our 64 per cent gas share, so we're making good progress there. Churn is an issue that faces everybody in the industry. We are actually starting to see churn rates falling, which will drive forward the profits of electricity as well.

Q.

The sum of your upstream and downstream profit is above what many may have been forecasting, but are they both sustainable in the longer term?

A.

We made over £800m of profit out of £932m of operating profit. So obviously it's a major core of our business. We are driving forward on our gas business. We added 1.3bn therms of gas in the year. We're adding power stations. We increased our production from our own power stations to just under 20 per cent and we're also buying forward a number of electricity contracts. So our upstream business, we think, is quite secure. On top of that, as I mentioned, we have a 64 per cent market share in gas and 22 per cent share in electricity, so together we think we've got quite a strong, stable portfolio.

Q.

The Morecombe Bay operation, though, is in decline and you've also bumped into some regulatory hurdles around the acquisition of the Rough gas storage, which may indicate that it's not going to be that easy to get control of gas storage. Are these kind of issues going to have an impact on upstream gas earnings?

A.

I think there's two issues there. There's gas and there's gas storage. Gas assets we're in the market for, and, as you've probably read, other companies are currently looking to sell UK continental shelf gas assets. So that's playing to what we think we're good at, which is managing mature assets and getting the value from them. Gas storage is a different issue. There isn't a lot of gas storage in the UK and Rough is 80 per cent of the total capacity, which is why we wanted to buy the business. We think it's a very valuable asset and one that we expect to be able to utilise going forward.

British Gas Home Services and Centrica Business Services

Q.

Home Services looks to be performing well, but how much room is there in there to increase turnover over the next few years?

A.

Home Services had a really good year. We made £61m of profit which was up 69 per cent and our turnover was up 12 per cent to over £800m. And if I look at the products that we sell,

home electrical cover, kitchen appliance cover, plumbing and drains, these are all growing strongly and we are really seeing value of the British Gas brand in the eyes of the customer. Some of our competitors use local plumbers for their servicing. We have British Gas trained engineers and that's really cutting through with the customer. We think there's a lot of opportunity to grow that really differentiated offering in going forward in the next couple of years.

Q.

You touch on the British Gas trained engineers. I know you scaled up the business, but you're now talking about recruiting over 3,000 more British Gas engineers. Does that mean that we've seen operating margin hit a peak in that business?

A.

No, I don't think it has at all. Our operating margins are about 8 per cent now and we have a long-term target to get that above 10 per cent. The issue of the engineers is an issue facing the whole of the industry. There aren't enough trained engineers around and British Gas has taken the lead to train more engineers. We've committed to train a further 3,000. In the last year we added over 600 new engineers. These are engineers that work for British Gas on British Gas business. And so we think that's actually good for our industry so we are investing in our engineering force. We actually think it will drive more usage by customers and obviously as we are constrained by capacity at the moment, we can price more differentially. So we are actually seeing differential pricing driving further value.

Q.

In your Business Services unit, you've grown organically and through acquisitions, but what kind of market share are you targeting going forward?

A.

We've had a really good year in Business Services. Our profit was £65m, which was up 48 per cent. We've now got about 27 per cent of the market for business services. Now compared with our domestic market where we have about 40 per cent share, we think we can grow significantly further from that 27 per cent much closer to 40 per cent and that's what we're targeting to do.

Q.

As you build scale, what further cost synergies, if any, are you looking for?

A.

The whole basis of our model is that we can grow turnover faster than our cost base and we are growing organically. Last year we grew 24 per cent so that's a great performance of organic growth. If we can grow our turnover and keep control of our costs, then obviously that drops through to the bottom line and that's the plan for Business Services.

AA, Goldfish and One.Tel

Q.

In your other UK businesses, it's been a mixed picture in 2002. The AA's been up, Goldfish has been down, there's some regulatory uncertainty around One.Tel. How are you going to ensure value creation across what looks like a disparate bunch of businesses?

A.

We'd like to think it's the same picture, actually. We're investing in our businesses for growth. If you take the AA, our core AA business is now generating profits of over £100m. This is a business in '99 that was actually losing money. We've invested behind the business and we're growing it. Now we have some new investments in the AA which are depressing profits at the moment. AA service centres, for example. But we think that will drive further growth behind the brand.

If I take One.Tel, we've been investing behind the growth again, investing behind the brand. Our profits were £2m but that was after charging £10m of new product launches for mobiles and for broadband. So again, now that we've got the scale in our business, we can drive forward on turnover and that will fall through to our bottom line.

Similarly with Goldfish. Now we are slightly behind our plans in Goldfish. It's taken us longer to migrate the cards to our own customer service. We now have that and we had it from November of last year. So we've had for the first time our interaction with customers. That's driving sales of loans. It's driving sales of savings products as well. At the end of the year we

had £286m of savings from Goldfish customers. So we are a little bit further behind in Goldfish, but again we've built our scale, we've built our banking platform and now it's all a case of driving growth and that's what will drive profits.

Q.

You say that you're a little bit behind in Goldfish. Does that mean you're not sticking to your break even target?

A.

No, I think we'll still be break even by the end of 2003 and that's what we've said and that's what our plans are designed to deliver. What that means is that we have to be successful in driving forward further loan business and also getting some further momentum behind our credit card business. Credit card usage grew by 11 per cent last year. We want to see more of that growth in 2003.

Q.

With all that said, how are you going to ensure value creation within what are distinct businesses?

A.

We have a group weighted average cost of capital of about 8.5 per cent and each one of our businesses has got to generate returns in excess of that 8.5 per cent. Now at the moment, if I take the AA, for example, we're slightly lower than our weighted average cost of capital. But as we drive forward with cross-selling, as our new businesses generate more turnover and growth, we actually think we'll get past our weighted average cost [of capital] and create real value. And the picture's the same for both Goldfish and for One.Tel. In One.Tel we're driving cross selling across our mobile offering and across our broadband offering. With Goldfish we set a target last year of 200,000 cross-sold products, which we hit. That's the sort of performance we need to see to ensure we get a spread, a return, over and above our cost of capital.

North America

Q.

In North America we've seen a year-on-year decline in profits. So can this region really be a driver for growth?

A.

Oh absolutely. The profit was £63m, it was down slightly. But the key issue is our turnover growth. Our growth in turnover was 46 per cent last year up to £1.1bn. So we're making real strategic progress in Ontario, in Texas and more recently we've announced a deal in Alberta. So we have made good strategic progress. But to build a business so quickly requires infrastructure costs, and that's what we've been investing in. We've opened offices in Houston, in Connecticut, driving further infrastructure to support our growth. So now we think we're well positioned strategically to get real value from that investment and we expect to see good growth in our profits in 2003.

Q.

Given that the liberalisation of the North American market does seem to have stalled somewhat, and you have a target of 10m customers by the end of 2003, is that still a relevant target?

A.

Absolutely it is, yes. At the moment we have about 5.5m customers. So we've made very good progress towards that 10m target. But we've recognised that opportunities for organic growth are actually slower than we had first imagined. So we are targeting acquisitions to get us to that overall 10m target. Now obviously acquisitions are deals which we will only do if they create value. If I take, for example, the deal in Texas, we've brought 800,000 customers. The value from that business in the time that we've had economic interest has been about £21m in four months. So it's a very good business. We can grow organically but we'll have to build the real scale through acquisitions and we're still looking for acquisitions, like the AEP deal, that we can create value from.

Q.

So should that be viewed as a milestone then? If we get to the end of 2003 and you haven't got 10m customer relationships, is that cause for concern?

A.

I don't think so. I think the issue for us it's the scale of our ambition. That's what we're targeting. We could already be at 10m customers if we'd done the deals we were looking at, but that wouldn't create value for shareholders. So we'll pick the timing of our deals. As I say, it will be dependent upon the timing of good acquisition opportunities.

Q.

You have also done a deal with ATCO in Alberta. You're allowed to walk away from that deal if there isn't deregulation in that market place. Is this the way forward in markets which are at an early stage of their evolution?

A.

I think we have to be cautious about where we invest. There's a million customers in Alberta and deregulation is on the statutes but hasn't been legislated for. So, we have to make sure that the rules operate in the way we expect them to and that's why we have the break clause if the rules aren't put in place as is intended.

Europe

Q.

You've a small presence in Belgium and you've recently entered what is seen as a tough Spanish market. You've a target of 5m customer relationships by 2005. Is that realistic?

A.

Yes, we think it is. We have about 800,000 customers in Belgium now and the market opens fully later on this year and we've entered the Spanish market on an organic basis targeting business customers. So we think we're finding our way through how to build businesses in Europe. The target we've set is by 2005, 5m. There's still plenty of time to go, plenty of opportunities, and as you know the market's fully deregulating by 2007. So we're still very optimistic, yes.

Q.

What is the long-term plan for Europe and what kind of capital investment are you going to need to put into Europe to achieve your goals?

A.

It will all depend on how some of the markets deregulate. Will they deregulate with generation assets, for example, or with distribution assets? If it's simply access to customers, similar to the deal we did in Belgium where 800,000 customers cost us about £50m, then looking at customers alone, the amount of capital absorbed is actually quite low. So it will depend on how the market opportunities emerge over the next few years.

Dividend and outlook

Q.

So overall across the Group how long can this level of proper growth continue without improving returns from your recent investments?

A.

I think we recognise we've been investing heavily in strategic opportunities like North America, like Telecoms, for example, and like the financial services. Now is the time in 2003 and going forward when we'll actually start to see real delivery from those strategic investments. Our return on capital at the moment is about 19 per cent, which is pretty good. But we think that focusing on delivery as we go forward will drive that capital efficiency, drive profitability and drive the returns on capital up further. And that's what we're looking for in 2003.

Q.

Now by increasing your dividend by 29 per cent, is that a one-off and if it's not a one-off does that mean that you're scaling back some of that high growth ambition to become a more defensive or traditional utility?

A.

We've raised dividends 29 per cent but you have to recognise our earnings were up 32 per cent. So we're really paying out in a similar ratio to what we paid last year. But we are signalling, if you like, that we feel very confident about our core business. We feel confident about the paths to growth in our new investments and that's underpinning our confidence in

raising the dividend. So no, I don't think it's a one-off decision in any way and we expect to see further growth in earnings and cashflow going forward.

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