Centrica - Investor Day - North America Business Direct Energy

Tuesday 28 June 2011

Sam Laidlaw: Chief Executive

This is the first of three Capital Markets days that we'll be having this year, today obviously focussing on North America. We then have one in September at our Leicester Academy that will be focussing on British Gas. And in December we have one looking at our upstream business, so you'll really see the three big businesses of Centrica during the course of the year and we hope to unpack them in a little more detail.

The programme today is that I'm just going to make a very few introductory remarks, then hand over to Chris Weston who is the President of our North American business and a main Board Director, and James Spence who is our CFO of our North American activities, and Nick Luff is also on the panel, known to many of you, who's here to answer all the difficult questions. But I think between the four of us hopefully you will get a good overview and we'll give a general presentation before we then open it up to questions and answers. We then take a break at 10:45 and come back and Badar Khan who runs upstream for North America will give you some market context, and Maura Clark who runs our C&I business in North America will talk about the downstream market context. And then we'll take a break for lunch and come back and have a series of breakout sessions on each part of the business unpacking them in more detail.

So that's the programme and I hope that you'll be able to stay with it during the whole day because actually I think you'll find the breakout sessions in the afternoon particularly useful.

So let me just set the scene here in terms of how North America fits into our four strategic priorities. Last year at our Capital Markets Day which many of you attended, we set out four new strategic priorities. Firstly to grow British Gas and we're really making great progress in adding customers and growing that business, not only in residential energy customers but also developing the services business and leading the low carbon future and we'll come and talk much more about that in September, but we're on track to deliver that part of the strategy.

The second part of the strategy is all around delivering value from our growing upstream business clearly 18 months ago, two years ago we made two large acquisitions of our share of British Energy and Venture both of those acquisitions are performing very well, clearly the higher commodity prices has helped, but actually underlying that there's good operational performance both in Venture and in British Energy and we'll talk more about that at the end of the year.

But today really we're focussing on the third part of the strategy which is building an integrated North American business with leading positions in deregulated markets and that's important because we're really leveraging the skills and capabilities we've got in other parts of the Group and all of that to drive superior financial returns. So you'll see a theme throughout today we'll be talking about investment opportunities and how we're improving the organic performance of the business, but it's in a broader context of driving superior returns across the Group.

So why North America and what's the role of North America really within the Centrica Group? Well firstly we see in North America very large profit pools. To give you a little bit of context here there are some 80 million homes and households in North America that are able to take advantage of competitive deregulated markets, that's about four times the number of households in the UK and of course the average US household consumes two to three times as much energy. So this is a large and substantial market where we've already started to get key beachhead positions in Texas and in the Northeast we've got significant positions of size and scale that are growing and we'll talk about those. And we could continue to see the demand for energy and the demographics growing in North America at a higher rate than we're seeing in the UK.

Fundamentally we also want to leverage the skills and competencies we've got in the rest of the Centrica Group and in British Gas. We've clearly got a capability in managing an integrated business and how we manage across the value chain in a volatile commodity market, that's something that we want to leverage in North America. We've also, of course, with British Gas got a lot of expertise in customer segmentation, in propositions, in billing systems and in new technologies enabled through the smart meter and again we want to leverage those competences. And we want to develop a services capability. And we took a big step forward as you'll see in today's presentation with Clockwork to really drive energy efficiency in the home in North America in the same way that we're doing in the UK.

And finally, apart from the organic growth which you'll see as significant, we also want to continue to build on inorganic growth with investing with tactical acquisitions, remaining disciplined as these have to compete with opportunities across the Group but I think you'll see the results of some of these in today's presentations.

So what's our progress been in North America? Over the last ten years and we have been now investing in North America for ten years, so this is not a new start up, but it's been a steadily growing business. And over the last few years although despite the high rate of growth we're also delivering returns above our cost of capital and we're really starting to deliver value and profit to the Group and we expect that to continue significantly as we look forward. We've got I think a profitable downstream business in the key deregulated markets of Texas and the Northeast. We're now the third largest C&I marketer, particularly of electricity, Maura Clark's business based in Pittsburgh that she'll talk about, and we're also now a leading services provider, so we're really starting to put all the pieces of the jigsaw together to actually develop a strong integrated business under Chris' new team.

We talked at the Capital Markets Day about integration and actually building a structural hedge we're building a large upstream business and you'll see during the course of today's presentation the progress. We're making particularly on upstream in adding to our gas production to provide that structural hedge in a low price environment.

So I think that gives you a sense of the progress we're making. A strong financial track record under a new management team, Chris will talk about his new management team, you'll see a number of new faces, they're all here for the breakout sessions this afternoon, so you'll get a sense as to the depth of the team as well as the top leadership. I think very good progress towards the overall target that we set out at the Capital Markets Day last year to remind you we said we want to double the profitability of this business over the next three to five years. And when we actually look at the progress that we've made both organically in taking costs out of the business, improving the number of customers that we're adding together with the inorganic progress that we've made with small tactical acquisitions you'll see we're making very strong progress against that objective and that's encouraging to see.

But you'll also see the future growth potential of this business. And building on our existing capabilities, building on our existing markets where we've got knowledge and where we've

got understanding, the potential of how we can actually go further to actually achieve our aspiration of becoming the number one and two in our chosen markets. And how we can also continue to invest upstream even in a low gas and power price environment to create value. We've made more progress here in gas production than we have in power generation and we'll talk about that. And also how we can develop our services business, so these three engines of growth you'll see coming through very strongly in the presentations today. Whilst remaining very disciplined in the capital we deploy, clearly we have headroom and the opportunity to do larger acquisitions, but we're remaining very focused and very disciplined and it will depend on the quality of the opportunities that present themselves.

So that's the overall strategy. I will now hand over to Chris who's going to talk a little bit more about the North American strategy and then he'll hand over to James and talk about performance to date and what that actually means for the different parts of the business. So with that, Chris, let me hand over to you. Thank you.

Chris Weston: President and CEO, Direct Energy

Thank you, Sam. Good morning ladies and gentlemen. Before I go into detail about Direct Energy I'd like to provide you with some context around the North American market first on the US economy and then some thoughts on energy markets covering Upstream Gas, Power Generation and Retail. I will then go on to outline our strategy, demonstrate the progress we have made - specifically the efficiencies we are driving within the organisation, the growth that we have achieved and the acquisitions that we have successfully integrated. Direct Energy's strategy to build scale downstream and increase the level of vertical integration will drive growth and will be delivered both organically and through acquisition, with investment in existing assets and acquisitions all falling within the financial framework and discipline required by the Group. I will also go into DE's growth in more detail covering each business unit in turn Retail Energy, Services and Upstream. James Spence, our CFO, will then talk about the progress we have made in a financial context.

So first of all the US economy as you know GDP growth is returning, is probably a little weaker than expected but most commentators see little likelihood of a double dip recession and growth is expected to be around 3% this year. US unemployment at 9.1% is a concern for Obama's re-election campaign and is certainly an important part of the current political manoeuvring. Overshadowing all of this though is the US national debt at $14.3 trillion and climbing $175,000 for every family in America. National debt has hit the legislative ceiling and as you know Congress is negotiating a higher ceiling which is expected to be agreed on or before the 2nd August.

This along with the deficit and budget are dominating the political agenda and leaving little room for any other issue including energy. Energy policy is seen as important but not a priority. There will be no federal carbon legislation in the near future probably for at least the next three years and there are efforts underway to curtail the power of the environmental protection agency, the EPA, and to make the current rulemaking more pragmatic. These rules will however impact reserve margins principally through coal retirements this would in turn increase power prices benefitting DE's Texas generating assets.

At the state level particularly in the Northeast the regulatory situation continues to evolve. There is increasing recognition of the benefits of competition principally the cost efficiency this provides and therefore the savings to the customer. Consequently regulatory regimes are increasingly evolving to encourage market entry and competition which will again benefit the likes of Direct Energy.

Let's move to upstream gas production. Gas production in North America is huge at 26 trillion cubic feet per annum generating a profit pool of around $25 billion each year. The

game changer is shale gas which is already bigger than all of the UK's gas production. Shale is now some 20% of domestic production and is expected to continue to grow. This will drive a disconnect with UK NBP prices for the foreseeable future. Shale is attracting capital with a considerable amount of investment from Europe and the Far East and export is becoming a possibility although it will take some years yet to unfold.

There is also growth in domestic demand, largely from power generation which is growing at about 3% per annum, twice the overall demand rate. And there is debate as to whether the existing low prices will create new sources of demand. Without doubt gas will continue to play an important role in the US economy. This is important for Direct Energy as it could drive further opportunities across the energy value chain. In Services as customers switch fuels to natural gas appliances, in Retail Energy providing a better near to medium term opportunity to expand customer bases and of course for upstream gas production as production increases to meet demand.

So moving to power generation and to understand the scale of it first on the top left you can see power generation in the US compared to the UK, not surprisingly given the vast differences in population, economy and demand etc the generating capacity is dramatically different. The profit pool in the US in those areas of the market that are deregulated and open to competition is around $15 billion per annum. The economics of power are driven by the input fuel, gas, coal etc and reserve margins in the system.

North America is managed by ten independent system operators, or ISOs for short, with seven in the US. In the two markets that we are particularly interested in ERCOT, the ISO covering the vast majority of Texas, and PJM the ISO covering most of the US Northeast, we expect reserve margins to shrink over the next five years and the economics to improve supporting new build and improve returns from power generation. This is a key factor in our thinking around the potential to invest in power assets and the importance of vertical integration.

Coal is an important part of the generation fleet and although there are concerns about the environmental impact and the EPA rulemaking driving retirements it is expected to continue to play a large role over the next 20 to 30 years. At 30% of the US power generation fleet it will take many years to move away from.

Notwithstanding that gas fired generation is expected to increase providing a pragmatic solution to climate change concerns driven by a readily available source of low cost domestic gas, shale gas, by recent events around nuclear and the current debt situation. And so tightening reserve margins, coal retirements and the emergence of CCGT bills support Direct Energy's move towards greater vertical integration where it has customer load, particularly in the Northeast and Texas.

Next moving to retail. By way of background essentially there are three types of regulatory market in North America. Uncompetitive or fully regulated markets, fully competitive or unbundled markets, so Texas for power and Georgia for gas - these are structured like the UK, retail being separated from pipes and wires and from generation and production. And lastly hybrid markets of which there are over 20 in North America with 16 in the US Northeast alone. In hybrid markets billing services are provided by the regulated utility which also competes in the retail market. These markets are increasingly restructuring moving towards structures that support competition. There is a growing political consensus around the role competition plays in energy markets a recognition of its benefits both those of economic efficiency and those of innovation. This is gaining momentum helped by the recent Republican victories at State Government level and accelerated by increasing interest from multiple competitors, particularly utilities who are looking for growth outside their regulated utility areas. This is a virtuous and self-reinforcing circle credible competitors reinforcing

competition and its benefits, encouraging appropriate regulation and market evolution. It is good for Direct Energy.

Markets such as Pennsylvania, a hybrid market in the heart of the US Northeast, where the Public Utilities Commission, led by its Chairman, Rob Powelson, is openly discussing moving away from the default service provider being the local utility and moving toward a more competitive market structure, much more like the UK. Markets such as Texas, an unbundled market, led by Chairman Barry Smitherman, a progressive and strong regulator open to innovation and supportive of change.

Retail markets are large and growing markets. The US Northeast, the largest power market in the world, has 53 million potential energy customers, and a profit pool of $7 billion. Growth is driven by underlying demand growth from economic activity, 1% to 1.5% each year the deployment of new technology, like smart meters and, particularly, by restructuring of markets, opening up to competition. This latter point is driving considerable growth in the US Northeast, where the competitive market is expected to grow at a rate of about 15% per annum, doubling in the next five years.

Typically, although markets have a large number of competitors relative to the UK, there is a degree of concentration. For example, there are over 50 competitors in Texas, but 80% of customers take service from one of the top five retailers, of which Direct Energy is the third largest. Net operating profit margins in the Residential Retail business change over the commodity cycle, but are typically in the 5% to 10% range.

In the Commercial and Industrial, or C&I segment, where markets are generally open to competition, as the financial crisis of late 2008 recedes, the market is becoming more competitive with over 90 players now. There is less concern about collateral stress and more focus on increasing market share. Vertical integration is becoming an increasingly important factor. Net operating profit margins are similar to the UK, with stronger operators, like Direct Energy, earning around 3%.

So that provides some market context. What about Direct Energy? Let's start with my team, who you will hear from throughout the day. We are structured as four market facing business units Residential, C&I, Services and Upstream. These are supported by three functional teams Finance, HR and Legal and Regulatory. This structure provides the benefit of focus on our customers, and clear P&L accountability.

So, Steven Murray, who joined us just over a year ago, is based in Houston, and runs the Residential business. Steven worked for Shell for 20 years, before joining MX Energy as Chief Operating Officer which he helped to become one of the largest energy retailers in the US.

Maura Clark has been with DE six years is based in Pittsburgh and runs DE Business. Maura worked with Goldman Sachs in New York before joining us to head up Strategy and M&A. Three years ago she moved to lead DE Business and has since completed the successful acquisition and integration of Strategic Energy and grown DE Business into a substantial part of DE.

Eddy Collier has been with the Group ten years and runs our Services business. Eddy has previously worked in British Gas Residential Energy, and also ran the British Gas Services Central Heating Installation business, successfully returning it to profitability and overseeing strong profit growth.

Badar Khan, based in Houston, has been in the Group nine years, and runs the Upstream business. Badar started life in DE before moving to the UK to run British Gas Business,

leading it over a period of strong profit growth, before returning to the US to the Upstream business a year and a half ago.

Our CFO is James Spence. He has been with the Group nine years, working in many different parts of the Group but immediately prior to DE he was in Centrica Energy as the FD in the UK power business.

Anna Filipopoulos, who looks after HR, is the newest member of the team having been with the Group for only nine months. Anna has previously worked in a number of industry segments, including pharmaceuticals, healthcare and retail food most recently with the Cara Group in North America, responsible for the HR aspects of a 40,000 person group.

Finally, Adèle Malo, who looks after Legal and Regulatory. Adèle has been with Direct Energy for five years, before which she was General Counsel at the Ontario Generator, a regulated body. She then saw the light, and joined the exciting part of the industry.

So an experienced and incredibly capable team.

DE has become a substantial business over the last 11 years, with a turnover of $10 billion per annum, returns in excess of the Group cost of capital, 6 million customers and 6,000 employees. The Residential business unit has 3 million customers, and is the largest of its kind in North America. It offers customers a range of products, including fixed and variable gas, power and dual fuel, as well as green and prepaid products.

DE Business is the third largest competitive retailer in the C&I market, and provided 40 TWh of power and 63 Bcf of gas to over 200,000 customers in 2010. Beyond its core product it also offers a suite of products to help customers manage the commodity, both in terms of pricing and billing and also in terms of efficiency.

To complete the Downstream business we also have Services, which since the acquisition of Clockwork has become the largest services business in North America, with 2.8 million residential and business customers. It operates under the DE brand, as well as the three new Clockwork brands of One Hour, Benjamin Franklin and Mr Sparky and provides heating and cooling services, as well as plumbing and electrical services.

In Upstream we have two principle businesses, gas production and power generation as well as a small but growing midstream business. Our upstream gas business is based in Alberta, producing about 60 Bcf per annum, with over 600 Bcf in reserves. Through the acquisition of Wildcat Hills last year we also have some interesting development opportunities, and power generation is in Texas, in ERCOT, and consists of three CCGT plants, with a capacity of 1.2 GW.

Direct Energy is augmented by the capabilities that we have across the Centrica Group. Centrica in terms of British Gas and Centrica Energy operates in the most competitive energy market in the world in the UK. This brings a number of capabilities that can be readily redeployed into North America. The capability, experience and understanding of the importance of the interface with government and regulators is extremely valuable and helps to find the positions and lobbying strategy adopted in North America. It is indisputable that we have a strong and extremely relevant retail operational capability. British Gas now has an enviable track record of excellence in this area, and much of this can be redeployed into North America.

We are experts at managing an integrated business that encompasses the complexity of operating both upstream gas production and generation assets, and also the efficient provision of load to our customers.

Lastly, and to some extent more recently, we have built capability that positions us well for a low carbon future. That is both through the services capability the Group has, but also more recently the smart metering capability that we are building in the UK, knowledge that we can deploy into North America over time. Group experience and capability undoubtedly reinforce the platform that we have built in North America.

At its simplest, our strategy is about building scale and vertical integration, but in more detail it can be broken down into three areas; improve, grow and invest. Firstly improving what we already do. Essentially this is all about delivering returns above our cost of capital, making sure that we are efficient and cost effective. An important part of this is the service we provide to our customers as we become more cost effective it is important that we also continue to improve the service we provide to our customers. And so our ambition is to become the most recommended energy and services provider.

Secondly, it's about growing scale downstream namely being a leader in our core markets in Residential and C&I, and substantially growing our Services business to enable us to take advantage of the energy services overlap with all its attendant benefits in the future.

And lastly, it's about building a vertically integrated business, generating good returns upstream over the commodity cycle, and creating a more balanced business, investing in gas production and investing in power generation where we have customer load. In short, the strategy is all about scale and vertical integration.

Now, as with Centrica in the UK, both scale, local scale and vertical integration are key. Scale and its associated benefits are well understood. And vertical integration is important in the US for similar reasons to those in the UK. First it provides earnings stability. In the short term it protects against price volatility driven by extreme short-term movements in demand or supply. Similarly, in the long term it ensures that as a company you are less exposed to margin pressure in any one part of the value chain, allowing a more consistent return to be earned over the commodity cycle. Vertical integration also brings benefits in terms of reduced transaction costs, not having to pay the full bid ask spread, portfolio optimisation and reduced collateral requirements.

In North America the degree of vertical integration required is less than that required in the UK, due to the greater liquidity in the markets. We are targeting about 35% to 40%, possibly higher, when you consider competitor positions. It is worth noting that vertical integration becomes more important as reserve margins tighten and these will undoubtedly tighten over the next five years or so. Vertical integration is an important component of our strategy.

Overall we are making good progress against our strategy. In 2009 we delivered around £200 million in operating profit. As we indicated at the time with the Centrica Capital Markets Day last year, we are targeting a doubling in the profits from this business to £400 million in three to five years. Last year we made significant operational and financial improvements, posting a 10% increase in underlying operating profit with the Downstream business up 35% and importantly DE continued to earn returns in excess of the Group cost of capital. This was achieved despite weak commodity prices, the roll off of our Upstream hedges, and the consequent losses in the Upstream business.

This year we expect continued growth, and we expect to achieve the doubling of our business with growth through our existing businesses balanced with growth through acquisitions. So, where is the growth going to come from? At a high level there are five basic building blocks to growth in addition there is potential further acquisitive growth. Firstly, there is growth in the market itself new markets opening up to competition, markets where

regulatory change has improved the competitive market structure, and demand growth driven by population growth or industrial demand.

Secondly, there is potential to continue to grow our market share, both in the energy and the services market. Next, operational excellence, reducing cost, and making more of Direct Energy's North American scale. Over time we expect additional growth from the juxtaposition of the energy and services businesses this could be substantial. Lastly, commodity prices are currently low any improvement will drive considerable growth and improve profitability in our Upstream business, both from existing production, but also from further development. We are well positioned to capitalise on commodity price upside.

Each of Direct Energy's business units is well positioned to pursue these growth opportunities. So starting with Residential, where good progress has been made in both operational improvements and in exploiting market opportunities.

Firstly, Texas, one of our core businesses, where we have both an incumbent and new entrant business. Under the banner of the transformation project the team has accomplished much over the last 18 months. They have controlled bad debt, driving considerable P&L benefit successfully consolidated billing and customer care platforms, with costs expected to fall by 30% and importantly improved customer satisfaction, with the net promoter score, or NPS, in Texas up significantly from -9 in December 2009 to 38 last month. They have stabilised the customer base, reduced churn and introduced the prepaid product - a great effort.

In the Northeast the team has driven strong customer growth, both organically and through acquisition. Customer numbers, including the Gateway acquisition, have doubled over the last two years and we now have close to 800,000 customers in this region.

So good progress to date, but undoubtedly there are challenges to the business. We are the largest competitive retailer in North America, but we are not number one or two in all of our core markets and that is something we are working to address. In the Northeast we do not have a billing relationship with our customers that relationship remains with the incumbent utility, and Direct Energy is just a line item on the bill. As a result, brand awareness in the Northeast is low and we have a remote relationship with the customer. Both regulatory change and the services business are important in rebalancing the situation and connecting more strongly with our customers.

We have also seen adverse regulatory changes in Ontario under the Energy Consumer Protection Act, or ECPA, which makes it extremely difficult to retain and acquire customers, and has inevitably resulted in a loss of customers. The ECPA makes a difficult market structure even more challenging. With the provincial elections in October a change in government would mark the beginnings of an improvement to this market situation. However, in the meantime we have reduced the cost base to ensure we maximise near-term profitability. Over time, the growth in Texas and the US Northeast will make up for the reduction in our business in Ontario.

As for opportunities, we have been very much focused on driving improvements within each of our regional operations, and have not yet taken full advantage of our scale across North America. This is being addressed now, and will reduce the cost base of the Residential business.

There are continuing opportunities to grow the business in the US Northeast, both organically and through acquisition. The market is expected to more than double over the next five years, and DE would fully expect to capture at least its current market share.

Lastly acquisitions there are opportunities out there, much like the recent Gateway acquisition, and we will continue to look for those that provide synergies and add capability. The DE Residential team is making great progress building the customer base, reducing costs, improving customer satisfaction and there are a number of growth opportunities for them to pursue.

So to DE Business. The progress here is obvious: the team has more than doubled operating profit over the last year, from £34 million in 2009 to £88 million in 2010. We have seen strong top line growth strong margin improvement at just over 3% last year, one of the stronger margins in the industry and trebled our NPS in 2010. The market is very competitive, and as the economy recovers we are seeing companies coming back to the market. Many of these competitors are large and already vertically integrated. Vertical integration in some instances can give an advantage in pricing, allowing them to build market share, as FirstEnergy has done in Pennsylvania.

Notwithstanding this there are considerable opportunities for further profit growth in particular in the small business segment we are focusing on a traditionally under-served segment of the market. We have organised around the segment, forming one team to focus on this opportunity, and we expect to see around 30% growth this year in the customer base. In addition the team is continuing to develop non-commodity products, branded 360Direct, providing both demand response capabilities, that is managing customer load in periods of intense demand, and energy management capabilities, so that is around energy efficiency and energy information. This is a very small business currently, but good growth is expected, and it adds important customer value to the core product set. Like Residential, there are further operational and scale efficiencies to address, and although not as numerous, further acquisition opportunities may also present themselves. Under Maura’s leadership the team has done a fantastic job, and I have no doubt they will continue to drive great results.

In Services, the Clockwork acquisition is proving to be transformational. The acquisition doubled market share to 4%, making us the largest services business in North America, in a highly fragmented market. It has provided a strong franchise capability, with considerable growth potential, good brands and good work management and deployment tools. It has also provided the vehicle to create a single pan North American business platform, allowing scale benefits, particularly in purchasing, which has a multimillion dollar benefit, and cost efficiency through common business processes.

The integration has gone well and has resulted in Direct Energy Home Services operations in the US migrating smoothly to the Clockwork brands and systems. This year the Canadian operations will be moved across creating a single business platform across North America. Important parts of the integration project are health and safety and customer satisfaction and the team has also made considerable progress in these areas. Safety of both our customers and our people is the first priority in this business: it affects morale and customer satisfaction. Direct Energy’s safety systems and processes have now been deployed into Clockwork, and we have seen accident rates reduce by 87% since the beginning of the year.

Customer satisfaction is also essential. We have technicians in customers’ homes every day. The team has deployed the NPS processes from British Gas Services, and as a result improved satisfaction to 70 in the US, one of the best in the industry.

The one headwind the business faces is the state of the housing market. Housing starts are at their lowest level for many years, running at an annualised rate of around 500,000, down from a high of 2.2 million. This impacts Direct Energy’s Residential new construction business, which following the integration of Clockwork and DE Services, will be run as a separate business. Furthermore, the heating and cooling, or HVAC, installation business, is impacted in a weak housing market, as customers are more inclined to repair rather than

replace. Even in this environment, however, there are a number of growth opportunities. The North American services market itself is very large, 130 million households, and a revenue pool of $75 billion in HVAC, plumbing and electrical plans, installs and repairs.

The majority of the services business is based on on-demand work. In Clockwork we have about 3 million customers, many of whom use us once every three years, providing a degree of repeat business. The opportunity is to convert these customers to protection plan or contract customers, much like British Gas Services thus providing an ongoing and dependable revenue stream. Protection plans or insurance products are already offered in North America indeed we have almost 800,000 protection plan customers in Ontario. By offering both on-demand and protection plans we will increase margins and create a more sustainable business.

Similarly the franchise business in Clockwork also presents expansion opportunities, both in its own right and in conjunction with a growing protection plan business which will rely on franchisees to fulfil service. The two together are mutually reinforcing, and will provide good growth for the Services business over the next few years. Though we are in 45 US states there is room to increase our presence and market share, especially in the large metropolitan markets across America. There is clearly the opportunity for further growth through acquisition, creating greater scale through consolidation. However, given the fragmented nature of the market, with a large number of very small players, this route is less likely.

Lastly, cross-sell and joint propositions to the energy customer base and vice versa will provide growth over time for the business. DE's existing customer base, where we have an energy services overlap, provides a 2 million customer opportunity through cross-sell although the energy services market is less mature in the US, and we will begin trials later this year. In summary, Clockwork is transforming the Services business and will provide a more material contribution to Direct Energy's operating profit over the coming years.

Lastly, looking at Direct Energy Upstream, Badar and the team have made good progress, especially in this low price environment redefining the strategy, reorganising and refocusing the Upstream operation into clear lines of business: Upstream gas, running the gas business in Alberta; Power Generation, encompassing both the CCGTs and the wind assets; Midstream, responsible for gas storage, transportation, asset optimisation and trading; and, lastly, Retail Portfolio Management, providing the interface between our retail load and the assets and trading capabilities needed to manage that load.

Without doubt 2010 was a difficult year for the Upstream business, rebuilding the team in a low commodity price environment while hedges came off. 2011 is expected to be better. The acquisition of the Wildcat Hills gas assets from Suncor and Shell was well executed, and the integration has been straightforward. The assets were acquired at very competitive prices, averaging $1.45/mcf of reserves, against industry benchmarks well above this. These transactions increased reserves by about 60% to over 600 Bcfe, and will reduce overall production costs, solidifying our top quartile position as a low cost producer in the Western Canadian Sedimentary Basin. In addition, the reservoir may provide considerable upside in reserves at low marginal costs. Original gas in place is large, and the deployment of shale type technology – that is horizontal drilling and fraccing – may allow much higher levels of recovery than originally anticipated under a more conventional drilling programme. Again, tests will be conducted later this year.

The power assets struggled last year in a low heat rate environment in Texas. Market heat rates, which are similar to spark spreads, are expected to improve as reserve margins tighten over the next three to five years. The team improved the reliability and operational efficiency of the plants, and as a result was able to take advantage of an extreme cold

weather event in February. Where a number of operators were caught short our power business performed very well. This demonstrates one aspect of the benefits of vertical integration but notwithstanding this, without a more extensive generation fleet and the benefits of geographic and fuel diversity, the power business with its current profile will struggle to deliver consistent earnings.

There continue to be opportunities to acquire Upstream assets, particularly in gas in Western Canada however power asset opportunities are more scarce, especially as power asset valuations appear to be increasing as power prices recover.

So, in DE Upstream the story is one of low commodity prices. However we are making good progress with efficiency and operational improvements, whilst looking for further value adding acquisition opportunities.

In summary, the growth opportunities are significant, and we are making good progress in executing against these. Growth is returning in Texas and is strong in the US Northeast. The Northeast market is expected to more than double in size over the next five years driven by regulatory improvements, market entry and greater penetration. The small business customer segment will support further growth in direct energy business. We expect margins to be slightly higher in this segment, offsetting potential margin pressure in the more competitive C&I segment.

Services can expand both geographically and it's currently operating in 74 of the 100 largest US metropolitan areas and by increasing share in existing markets. Current average share in each territory is less than 5%. In addition the combination of the franchise and protection plan opportunities which are mutually reinforcing will provide differentiation and growth options for a number of years. Operational effectiveness and cost efficiency will improve as we continue with the Texas transformation programme, move to a pan North American platform and improve our procurement activities. In the medium term we expect continued growth from the energy services relationship driving both the cross-sell of individual products, the two million customer opportunity and the development of joint product propositions.
Commodity prices are expected to gradually recover rather than fall further as demand increases and reserve margins tighten. Our existing gas reserves are low cost and our CCGTs are well positioned on the supply stack. A $1 improvement in the gas price would improve Upstream operating profit by $40 - $50 million and a similar change in heat rate would improve Generation profit by $10 - $15 million. DE is well positioned to capitalise on any improvement in the commodity price.

So lots to go for and good progress to date. We have built a significant platform in North America over the last 11 years. We have a track record for organic growth and successful acquisitions and subsequent integration. We have demonstrated that we are able to deliver returns in North America above the Group's cost of capital. Given the Group's experience in competitive markets North America is a natural place for Centrica to invest and grow. We are well positioned for further growth. The market is large, significantly larger than the UK, and there are multiple opportunities to pursue both organic and acquisitive. We understand the market well and we have built considerable expertise. We have a clear strategy to build scale downstream and become more vertically integrated over time, all with the aim of delivering value to the Group.
Direct Energy will continue to grow and with Centrica's support and investment will become a more material part of Group earnings.

Thank you, and I'll now hand over to James who will talk about financial performance.

James Spence: Chief Financial Officer, Direct Energy

Thanks, Chris, and good morning everyone. As Chris mentioned I'm going to talk about the progress that's been made in the business focusing on the financials. And firstly we'll be looking at DE financial performance between 2008 and 2010 and then we'll see the key drivers that are expected to impact the financials moving forward. As we do this we'll look at Direct Energy on a consolidated level and by line of business.

First let's take a look at the commodity prices to provide some context. The graph on the left shows gas prices and AECO - for those not recognising it, this is the Western Canadian Index - and the graph on the right shows power prices in Texas. Between 2008 and 2010 you can see the sharp decline in gas and power prices. These commodity price movements significantly impacted the profitability of our upstream operations both in our gas assets and our power assets. However, while commodity price changes impact revenues in our retail energy activities the impact on profitability is less significant as we price based on achieving a targeted gross margin over time. In fact as you'll see when we look at our residential business the commodity price reduction led to an improvement in profitability in that business in 2010.

Taking a look at the forecast period you can see that the market does not expect a marked increase in gas prices based on the assumption of continued strong supply of shale gas in North America. Similarly power prices are expected to stay low in Texas where our generation assets are located as generation reserve margins are expected to remain healthy in the short term.

Despite the changes in commodity prices one of the advantages of our integrated model is that we've generated good returns on capital at a consolidated Direct Energy level through the cycle, offsetting the lower returns in our Upstream business with a strong performance downstream.

So turning to the financials and starting with a look on a consolidated Direct Energy basis. Starting with the top left chart you can see that operating profit increased to £234 million in 2010, despite the sharp decrease in the Upstream business, which was loss-making mainly due to the low commodity price environment.

Despite this reduction in Upstream profits, Return on Capital Employed was 8% last year and has been ahead of the Group's cost of capital through the 2008 – 2010 period and this highlights the good progress we've made in the retail energy businesses.

Revenues in Direct Energy were close to £6 billion in 2010, falling slightly from the prior year, reflecting the fall in commodity prices and a reduction in customer numbers as we focused on the most valuable customers.

In the bottom left chart you can see strong positive operating cashflows through the period with fluctuations in working capital between 2008 and 2009 reflecting the impact of commodity price movements.

The retail energy businesses have been strongly cash generative and the Upstream business only requires relatively modest levels of ongoing capex for maintenance of power plant and development of gas assets. We've a number of growth drivers and I'll cover these as we go through each line of business.

So turning to Direct Energy Residential, where we're the number one competitive energy supplier to residential customers in North America overall, with top three positions in Texas, the US Northeast, Ontario and Alberta.

In 2010 we saw a sharp increase in the profitability of Direct Energy Residential driven primarily by our performance in Texas where supply margins were wider than normal, largely due to falling commodity prices and a very hot summer, driving a higher than normal air-conditioning load. These factors resulted in a higher level of profitability than we would expect to see in this market under more normal conditions.

Combined with strong performance in the Canadian business, this resulted in ROCE in excess of 17% for Direct Energy Residential in 2010.

As you can see in the top right chart revenues dropped slightly in 2010, reflecting both the lower customer numbers and lower commodity prices. In 2010 we also saw the benefits of operational improvements, primarily in bad debt and cost to serve. These combined with the favourable Texas conditions result in improvement in our operating margin to around 7%.

As I referred to a moment ago customer numbers reduced slightly in 2010 as we focused our efforts on customer quality leading to some customer losses following on from bad debt issues experienced in 2009.

And taking a look forward, profitability in Direct Energy Residential will be impacted by the performance of the Ontario business due to the ECPA. However there are many opportunities for growth elsewhere in the downstream business. The main drivers will be continued organic growth, especially in the US Northeast markets where we've reconfigured our sales channels leading to increased sales at a lower cost. And the Texas market where pleasingly in the last few months we've seen customer growth for the first time in five years which is very encouraging for this part of the business.

We expect to deliver further cost savings as we achieve integration and scale benefits. For example, in Texas we've recently consolidated our billing platforms. We also see growth opportunities from increased segmentation and focus on the quality of our customer base.

We'll look to leverage our scale and create value for acquisitions. The Gateway acquisition in May of this year is a good example where we see significant synergies as we combine the business with our existing footprint in the US Northeast. This added over 250,000 residential customers an important new sales channel and has helped us to penetrate the New York market.

Turning now to our Commercial and Industrial business, DE Business. As you can see in the top left chart operating profit has risen sharply driven by strong sales growth in the US power C&I segment and by realising operational efficiencies and reduced cost to serve and bad debt charges where our performance is industry-leading.

The top right chart shows that margins have risen sharply to over 3% in 2010 which is a good level in this market. Overall our return on capital was nearly 20% in 2010.

The history of this business is the combination of Direct Energy's existing C&I business with Strategic Energy which we acquired from Great Plains for $300 million in 2008 and I'll come back and talk a bit more about that acquisition later on.

One of the keys to success in this business has been a focus on improving sales efficiency and productivity achieved through the optimisation of our sales channels and this has driven the substantial top line growth between 2008 and 2010.

So taking a look at drivers of future growth in this business as well as continuing to improve our operations and driving volume growth in the core C&I business we see the small business segment as underserved currently and an opportunity for us to focus on. And already in 2010 the progress we're making here is contributing to our growth and you'll hear Maura talking about that in more detail later on in the day.

So turning now to Direct Energy Services which provides energy-related services mainly to residential customers in the US and Canada. As you can see the reported profit dropped in 2010 although this masks the underlying performance of the business due to some small one-off costs we incurred relating to the closure of our loss-making appliance service business in Ontario and integration costs following the Clockwork acquisition.

Customer numbers and revenue both increased in 2010, following the Clockwork acquisition, and we're pleased to see the business performing in line with expectations and Clockwork will be the main driver of growth in 2011, primarily in the second half of the year, given the seasonality of the business. We'll also drive growth in the medium term as existing franchises grow, we take on new franchises and we realise operational synergies from our enhanced procurement scale and from combining existing opportunities with our US services business.

Our business in the US is primarily on demand. As Chris said, over time we see further growth opportunities in the sale of protection plan products which is a relatively immature market in the US and also from the energy services cross-sell with our retail energy business, similar to our UK model.

Our existing US services business also contains a sub-segment focused on servicing the residential new construction market which has substantially reduced in profitability between 2008 and 2010 in line with that market. It's now a small part of the business overall but offers upside if we see the housing markets recover.

Looking now at the Direct Energy Upstream business. This segment includes our upstream gas business based in western Canada, our three CCGTs and five wind PPAs in Texas and our midstream activities. We saw a sharp decline in the operating profit and returns from this business between 2008 and 2010 in line with the fall off in commodity prices. In 2010 we acquired Wildcat Hills, followed up with a further small co-located acquisition earlier this year. Together these will allow us to benefit from lower production costs and as a consequence our Upstream gas assets will be profitable this year even at the current low gas prices.

The first Wildcat Hills acquisition closed in October 2010 so the full benefits will come through this year. Overall the acquisition added approximately 60% to our reserves at an attractive price.

In the top right chart you can see the impact that the Wildcat Hills acquisition will have on production costs. The second acquisition, although smaller, will help to reduce production costs to an even lower level.

In 2010 our Power Generation business was impacted by some one-off costs in addition to the effect of the low commodity price environment. Sparks spreads remain low reflecting the high reserve margins in Texas and we expect this environment to continue for the time being although we do see improved opportunities for us to optimise the usage of our power generation assets in this market.

In summary, with reduced losses from the power generation business in 2011 and increased lower cost production from Wildcat Hills, we expect a notable improvement in Upstream results in 2011 and going forward.

So looking at the next slide, I'd like to spend a few moments looking at three acquisitions across our business in the last few years to illustrate how we've managed to create value from combining new businesses with the existing base built up over the last ten years at Direct Energy. We're a disciplined and focused buyer, acquiring assets that help us achieve our goals of expanding both our scale and the level of vertical integration in the business.

In 2008 we acquired Strategic Energy from Great Plains for $300 million. At that time profitability of our existing C&I business was under $20 million and in 2010 we reported operating profit of over $140 million. We moved the Direct Energy C&I headquarters to Pittsburgh, the headquarters of Strategic Energy and took the best parts of both businesses. The business has grown substantially and is now the number three C&I supplier in North America with strong further growth potential driven by continued volume growth in the core C&I business and from the small business segment as I referred to earlier.

In July 2010 we acquired Clockwork for $183 million. Clockwork provides us with the vehicle which we'll use for further organic growth in Direct Energy Services with its extremely strong brands and also as a consolidator if we acquire further businesses in this fragmented market. Clockwork has a large geographic footprint, it's in 45 of the US states and we see the franchise model as an additional channel for growth. The business has made a strong start in 2011 in line with our financial expectations and has also provided opportunities to realise synergies with our existing US services business.

Then in October 2010 and subsequently April 2011 we acquired two tranches of Wildcat Hills. We acquired these assets at attractive valuations, even based on current market prices as we see opportunities in conventional assets while other players have been more focused on shale. We also see upside opportunities on the Wildcat Hills assets through utilising horizontal drilling and fraccing techniques with tests due to be conducted later this year and we'll go into this in more detail later on in Badar's presentation.

So these are three strategic acquisitions where we've seen the opportunity to create value in the combination with our existing businesses and create returns in excess of our cost of capital. Each of these acquisitions has transformed the line of business providing us the opportunity to be more efficient and to utilise new capabilities which, in combination with our existing business, has allowed us to create value.

Gateway, acquired in May is a further example with similar attributes, fitting well with our base business and providing new capabilities and we continue to evaluate further acquisitions where we can see value.

So in summary we're making good progress across all of our lines of business and have established a strong financial track record. As you've seen returns on capital have been ahead of the Group's cost of capital between 2008 and 2010 and we're generating strong operating cashflows for the Group. Each of our four lines of business is well-placed to grow organically, building on our existing base and strong market positions.

We've also demonstrated our ability to create value through acquisitions, leveraging our scale, realising efficiencies, bringing in new capabilities and entering new markets.

So with that I'll now hand back over the Sam for the Q & A session.

Sam Laidlaw: Chief Executive

Thank you very much James and thank you Chris…thank you also for your patience as we went through the presentation but I think it was important just to lay out firstly the context, the strategy, which hopefully you got a clear sense of, the progress to date which I think has been very substantial, and the growth opportunities going forward in this business and I think with that context it's now a good opportunity to take questions and answers. And for the benefit of those on the webcast it might be good just for everybody to mention their name and where they come from.

Question and Answer Session

Question 1

Lawson Steele – Espirito Santo

Two questions. How much of your growth is going to be organic do you think versus acquisitions? And secondly if we look at the fact that you've been there for ten years now and the growth really has come of late, could it have come earlier? What's changed?

Answer: Sam Laidlaw

Perhaps I should take this one. I think because what we said at the Capital Markets Day last year, which remains the case, is that we expect little over half of the growth moving from £200 million of operating profit to £400 million of operating profit to actually come from organic improvements and I think that remains the case. We, I think, still can see strong performance organically but it's roughly 50/50. Obviously the inorganic will very much depend on the quality of the opportunities and the reason we're not setting a more explicit timetable than the three to five years is that we're not going to do this against the clock, it will be about value creative opportunities and I think that's very important.

Could we have done it earlier which is the second part of your question. I think the new team, the new platform that we've got, the new systems capability and also leveraging a lot of the skills and propositions that we have been developing in the rest of the Centrica Group, particularly in British Gas, has really been something that I think we've only been able to do in the last 18 months. Clearly at the Group level we were very focused on fixing the structural hedge in the UK and fixing the service level and cost structure of British Gas in the period five years ago to 18 months ago. More recently, having corrected that, we obviously focus on driving the performance in North America.

Answer: Chris Weston

Of course if we had more assets earlier Lawson it would have been in a higher price environment wouldn't it?

Question 2

Scott Phillips – UniCredit

Two questions please. I think you mentioned several times in your presentation that you believe demand growth will underpin earnings growth I just wondered to what extent you believe this to be true in a world of sustained high commodity prices putting pressure on households and also the effects of increasing efficiency through smart metering etc?

And then secondly turning to the Texas power market you mentioned that you expect the system to tighten but you also mention that you expect it to be well supplied in the short term so really when do you expect to see tightening coming through into spreads?

Answer: Sam Laidlaw

Maybe I'll take the first one and let Chris take the second one around the tightening of the Texas market. But the first one in terms of demand growth - what we are continuing to see, unlike the UK where gas consumption is actually declining, in the residential level we're continuing to see energy demand increase in North America. Now, given all that we are doing in energy efficiency and the roll out of smart meters, as you rightly say, over time we

expect that to plateau. But in the same way that we expect to compensate through both growing market share and also growing Services' propositions that actually have strong margins in them, we think that will be a good business for us. So if you take the analogy of the UK where our Services business has much higher margins than the sale of energy we think that that's something we want to get on the front foot of in North America. And if you just look at the average energy consumption of the North American home, which is two and a half to three times the UK home, the opportunity for energy efficiency advice and products is very substantial and we'll talk about that a lot more in the Services breakout session because we think that actually will be a bigger engine of growth than the growth in the underlying demand for the commodity.

The second part of your question I think was all around when are given oversupply in Texas and relatively strong reserve margins at the moment, you know, when's that going to compress and turn into higher power prices.

Answer: Chris Weston

Yes, and also I think in addition to Sam's answer there the other thing driving growth will be deregulating markets and we are seeing a quite considerable move towards that and that is a prime driver in the growth of the business, particularly in residential in the Northeast, so that's an important factor.

As to Texas and reserve margins, reserve margins are above the target reserve margin in Texas at the moment, we expect that to be the case for the next two to three years, we expect reserve margins to be tightening and shrinking below the target reserve margin in about five years. The degree of uncertainty is because of how the EPA rules around coal in particular, environmental protection, are going to play into the Texas market, and that is not quite clear, there's one obscure rule in the Clean Air Act around water cooling that could accelerate it before five years, but it's about five years so the short term, as James says, we see reasonable reserve margins, about five years' time we expect those to tighten and the heat rates to improve to encourage new build.

<u>Question 3</u>

Martin Brough – Deutsche Bank

A couple of questions. Firstly it was mentioned that the market for making acquisitions of generation assets is a bit scarce at the moment in terms of finding things at acceptable cost. Would you consider joint ventures as an alternative, because obviously I mean International Power seem to have similar aims in terms of being more vertically integrated in merchant North America, but equally there might be local players in North America with merchant generation assets that would welcome a bit more integration on their customer side in a JV kind of structure.

And then secondly, just as a higher level view, I guess as a CEO of a business from the UK going into the US, are you sort of conscious of areas where other UK FTSE 100 companies have had disappointing experiences in North America and are comfortable that the model that you're sort of pushing ahead with in North America is different and that you won't find similar problems.

Answer: Sam Laidlaw

I mean both very good questions. The first one was would we look at joint venture structures? I mean we look at lots of different structures, clearly, but I think we need to be convinced firstly that there is alignment of strategy and there is also alignment of value.

Obviously I don't think it's a particular secret that we talk to International Power and we talk to lots of different people, but if we don't at the end of the day see the returns are going to be there because we're actually having to contribute more value than we're getting out of it then it's not going to work even if strategically the integration model may have some attraction. So we're very focused on value but we wouldn't preclude joint ventures if we could find the right opportunity. And I think as came out in the presentation we're being patient on power, we're looking at a lot of power generation assets and we will make offers at a value that is going to be good for our shareholders rather than for the counterparty.

I think your second question was around clearly the track record of UK companies and indeed some European companies investing in North America has been patchy. Are we conscious of that? Absolutely. Do I think that we have a different proposition? Yes, very much so in that if you look at in the utilities space what has typically happened is that companies have invested to buy regulated utilities and frequently found that actually the synergies that they were hoping to extract and the efficiencies that they were hoping to gain have been given back to the customer through the regulatory consent basically and therefore a lot of the value of the consolidation has actually gone straight back to the customer rather than to the shareholders. In deregulated markets which is our proposition clearly, you know, what matters for us is actually having a competitive pricing proposition and leveraging our skills. So I think we can, and provided we stick with areas where we can leverage the skills that we have we can be successful.

I've spent most of my working career in North America and a number of other members of the management team have too, and we've been at this now for ten years so this is not a sort of new step out for us, this is an area where we probably are more comfortable than many other UK companies and it's an area where we're only going to focus on those areas where we've got genuine competitive advantage.

Question 4

Ashley Thomas – MF Global

You flagged the difficulties in the Ontario market, could you perhaps give us a broad feel for the proportion of residential supply and residential profits that are currently derived from that market? And then just on the Upstream gas assets could you give us a feel for the type of gas assets they are and the relative merits of say shallow gas versus conventional or shale gas? Thank you.

Sam Laidlaw

Chris, do you want to take both of those?

Answer: Chris Weston

Yes. First on the Ontario market what we've had there is as you heard recent consumer protection legislation that has exacerbated a difficult market structure. Our immediate focus is on ensuring that the business is as profitable as it can be. We have seen a loss in customers and that has inevitably led to a loss in profit. About a quarter of the residential profit is generated in Ontario and over time, as I said in my speech, in my presentation, we would expect that to made up from growth in US North and Texas.

We are working with the government and the regulator and particularly the opposition on what needs to happen to the market structure and should the opposition be successful in October at the elections then we would expect to start seeing market structure improve. So that's where we are on Ontario.

Further question

The 25%, is that residential combined or was that residential supply, because you've also got the Services business?

Answer: Chris Weston

That's residential energy supply, it's about a quarter of that.

Further question

And of Services?

Answer: Chris Weston

Well, we don't look at it, I mean Services is a separate business.

Answer: Sam Laidlaw

We don't have the issue in Services that we have in residential supply, the issue is all around how we can actually retain energy customers, not Services customers.

Further question

Okay, so when you lose an energy customer you don't over time lose the Service customer?

Answer: Chris Weston

No, the relationship between energy and our services is less pronounced in North America, less mature than it is here in the UK and that's a tremendous opportunity for us. In terms of gas in western Canada conventional versus shale, I think the detail of the technology and how it works, it may be easier to cover that when you get to Badar Khan's Upstream presentation a bit later. But shale is a much lower porosity gas bearing formation, it requires a different approach in terms of fracturing the rock to release the gas and the more famous shales in North America are not in the western Canadian sedimentary basin. There are some but the more famous ones are in the US Northeast, in the Marcellus and further south in Texas. Now, that technology, that fracturing of the rock, can be taken and applied to a conventional asset and the conventional asset, the reservoir, may have been exploited for the last 20, 30, 40 years but it hasn't been developed with a view to what you can do in deploying this new technology and that may allow higher levels of recovery of the gas in place, and that's an interesting opportunity for us to explore in western Canada.

Now, those are more conventional type wells in western Canada. If you come further east and you go more into the plains you get shallow gas and that is a completely different prospect. As Wes Morningstar would say, you take your rig out into the prairie, you drill your hole and it's much lower flow rates and you hardly ever get a dry hole risk, it's a much lower cost operation, so it's relatively straightforward, and we have both shallow gas in the Prairies and we now have more conventional, a more interesting reservoir in Wildcat Hills which is in the foothills of the Rockies.

Answer: Sam Laidlaw

And incidentally, the horizontal drilling and multiple fraccing is also a technology of course that we deploy extensively in the southern North Sea so it's something we're very comfortable with.

Question 5

Ajay Patel – UBS

Morning, Ajay Patel from UBS. Two questions please. Firstly, you're highlighting quite a lot of growth opportunities, £2 million of cross selling opportunities within energy services, potentially a doubling of the market, or competitive market in the Northeast. Do you have the infrastructure in place to sort of accept that level of growth and how much would you have to spend to develop it or would it be developed from acquisition? Some commentary around that would be great.

And then the second question is what was the supply margin in Ontario, Texas and the Northeast as an average in 2010 and how do you see that on a normalised basis going forward? I'm just trying to gauge the profit opportunity in the Northeast.

Sam Laidlaw

So I think your first question, Ajay, was around do we have the infrastructure and how much capital would it require if we have to invest in it to support the services growth? Was that, or the cross sale generally?

Ajay Patel

The cross sale, but also the Northeast supply opportunity as well - it's quite heavy numbers.

Sam Laidlaw

Chris, do you want to take that?

Answer: Chris Weston

I mean as you recognise, good growth opportunities. The infrastructure that we have in place will largely support the opportunity ahead of us, I mean we do have, because we've grown through acquisition a fairly diverse set of applications, we are working to integrate those which will reduce costs, I'm not seeing huge investment requires, there will be ongoing capital requirements to do that, but the basic infrastructure will support the majority of the growth that we're going after over the next three or four years. There will be some incremental capex, but nothing particularly material.

In terms of the profit margins I think we disclosed in 2010 that the net margin was around 7% in the residential business, it differs by different region. There was, as James said, there were expanded margins in Texas due to heat and the way the commodity price moved and that may come down a bit as the commodity price rises, but I think the direction that I gave of net margins being in the 5% to 10% range is what you would expect going forward.

Question 6

Lakis Athanasiou – Evolution Securities

Two questions. One on the structural hedge, I'm struggling a little bit to understand what you mean by that because you seem to be focusing on power generation, okay you mention gas, you're rolling in fixed contract prices from the C&I and you have a lot of residential sales which are on fixed price, particularly in the Northeast, okay not so much in Texas and the focus on power generation seems to be, again very different to how you seem to present it in the UK, because you don't include the marginal power generation plant in your structural hedge consideration there and you seem to be looking at that as some kind of dependence on reserve margin signing and margins therefore expanding in power generation. Could you expand on that a little bit?

And the second point is to do with reserve margins, okay, we're seeing supply and demand in Texas tightening up, you're suggesting it, ERCOT's suggesting it, but can you truly get expansion in margins in such a low gas price environment or are we just going to go through and have average price margins quite low and one or two spikes during the year?

Answer: Sam Laidlaw

Let me take… perhaps if I make a start on the first one, because it's a complicated question, it's a very good question. How do we look at the structural hedge? I mean part of this is around clearly covering the price exposure, part of it is around actually for our, although our C&I business, you're absolutely right, some of that, a lot of it is fixed price, actually by covering that load we are effectively reducing our collateral requirement which therefore enables us to price more competitively. So you've got two different phenomena here. And then there is the whole question of shaping which is particularly applicable in the electricity market, where you have big intraday spikes or as we saw in Texas in February, very significant weather events. So you're really trying to cover for three different eventualities.

The first one which is the sort of long term pricing phenomenon, because we fundamentally believe that the US is a better supplied market than for instance the UK is and also because it is a much deeper and more liquid market where we're able to go and buy a large amount of the commodity to satisfy our needs on the open market more easily than we are in the UK where we would move the market against us is less of an imperative and that's why the overall hedge targets are lower. But when you look at the volumes of particularly power that we're selling in the C&I business under Maura Clark's business then clearly we need to cover that collateral exposure and we also need when you look at power in Texas and indeed in the Northeast where you see some intraday volatility we need some cover for that.

And that's what drives us to the very, the high level target of 35% to 40% on gas and power. Now, where we are today we are on gas with the two Wildcat Hills acquisitions, we are a little bit below 35% and so there's room potentially to do a bit more there. On power, we only have our three power stations in Texas and so we are effectively uncovered in the Northeast and if we can find opportunities for value then obviously that's something that we would be interested in pursuing. But only if we can do them for value.

I think, Nick is there anything more…? Chris you'd like to add to the structural hedge?

Chris Weston

No, I think you've covered it extremely clearly, Sam.

Sam Laidlaw

But it is complicated because you've got different motivations. The second part of your question was around how, if we have low gas prices will we actually see improving spreads in Texas? Do you want to cover that one off?

Answer: Chris Weston

Yes, certainly. I mean, predicting, forecasting what reserve margins are going to do, as you know, is not a precise science, but when you look at the Texas market, as I said earlier, the EPA rules and how they play into it will have an impact. There are already planned retirements for plants. And then the thing you can't avoid is the demand growth, as the economy recovers and that is certainly a strong point in the Texas market. So at some point, at some point those reserve margins will become too narrow and there will be a reaction by the market to the price of power and whether that will support the fundamentals required for new build. And we think that will happen in about five years' time.

Now, I think even in a low gas price environment you will still get that market signal. There is some debate as to whether Texas which is a power only market will have to move to a capacity type payment mechanism, in addition to that to try and ensure and guarantee new build, but that would support what we are trying to, or the operation that we have in Texas and what we are trying to do.

So, it's not a precise science, it is something that is being debated as to whether you need a capacity mechanism as well. I think that even in a low gas price environment with the way that demand is growing you will see an expansion in the market heat rate that will move to encourage new build.

Question 7

Edmund Reid – JP Morgan

Two questions. Firstly on the Services business, North American Service margins look like they were about 3% last year compared to British Gas Services margins which from memory are about 15%. I wonder if you can just talk us through the structural differences, where you think the upside potential is with regard to North American Services?

The second question is regarding the collateral requirements of the North American business. From memory, and I may be wrong here, but the Group provided quite a significant letter of credit to the North American business to support trading and I was just wondering if that was still the case and if as the North American business grows that the collateral requirement will increase?

And a subsequent question is how you adjust your return on capital employed for that.

Sam Laidlaw

Why don't I let Chris take the first one, James take the second one, and Nick take the last one.

Answer: Chris Weston

Thank you, Sam. So the Services business in North America, yes, the margin is less than British Gas Services, as I found out when I went over there. It was lower last year, I think it

was depressed because of the one off costs that we took in terms of closing the appliance business, the Canadian appliance business, and the integration costs.

I think the biggest difference that you have got between the two businesses is the business in North America is much more heavily weighted towards an on demand type business, and you don't have the protection plan business you have in the UK which allows I think for much greater segmentation and management of a customer base through a segmented marketing approach. So that is the biggest structural difference and why we want to start moving the business towards that type of business. So the on demand market is much more immediate, I suspect it is more competitive, so in the longer term margins will be lower in that business than the 15% that you see in the UK business. So I suspect that over time we will probably get them to 8% to 12% and that's the type of margin that you would see in that business as it develops more towards a protection plan business.

So that's the answer on that, James, do you want to talk about collateral?

Answer: James Spence

So collateral requirements at the moment are approximately $500 million based on the current size of our business. They've come down substantially as the commodity price has stabilised at current levels. In terms of the impact as the business grows I think there are really two main drivers of the need for collateral, one is the movement in commodity price and the other is the size of the business overall. So I think if we see commodity prices increase and the business continues to increase, to grow, we will see some further collateral requirement, but at the moment it's pretty stable at around $500 million.

Answer: Nick Luff

Yes and I'll just add to that I mean clearly the issue with collateral is one of liquidity and the liquidity you have to carry in case you have to post margin when commodity prices move. The cost of liquidity today is a lot less than it was three years ago when we were at the height of the financial crisis, so we do build it into our pricing and we're doing it particularly for DE business so it's taken into account in the pricing. But I think some of the margin pressure we're talking about is actually from other companies having less collateral pressure than they had before. So it's less expensive than it was.

Sam Laidlaw

I suggest we take one more question, I'm conscious of the fact that you've been all very patient and we've got plenty of opportunities in the breakout sessions and subsequently in the day for further questions as well.

<u>Question 8</u>

Mark Freshney – Credit Suisse

Just three quick questions. Firstly, on the US, I mean you have a franchising model in services which you don't employ in the UK, how would you expect that to impact your margins?

Secondly, in terms of the sort of structural hedge, if you were to solve your electricity hedge perhaps with gas generation would that mean you'd have to do another acquisition of the magnitude of Wildcat Hills?

And my third question is just on if you like the paradox on potentially buying generation in the US. You mentioned I think in your results 18 months ago that prices were quite high which was preventing you from seeing value buying those assets, while at the same time you're now talking about reserve margin squeezes within five years but asset valuations haven't really fallen despite the fact that many of these assets are cashflow neutral. So is there a point where you have to bite the bullet and buy an asset that's not contributing to earnings in the hope that reserve margins do eventually pick up?

Sam Laidlaw

Three good questions. I'll turn over to Chris on the franchising model. I would make the point however that franchising models are not new to us, we have a franchising model with Dyno, so we do understand how the franchising model works. And if you look at Clockwork it's actually a combination, it's largely franchising but it also has some company operated activities as well. So, Chris, do you want to just talk about the margins in that and then we'll come back to the electricity hedge?

Answer: Chris Weston

Yes, I mean when you look at the margins in the franchising business they are for us as the franchisor they are wider, we don't have the same cost base supporting a directly owned and operated business to worry about and the returns are very good because you don't need many assets to support that, you are selling the franchises to third parties who pay you a percentage of revenue. So that's a very cost effective way, an efficient way to expand the business and get greater coverage across North America.

Answer: Sam Laidlaw

I think your second question was were we to buy gas fired generation does that then increase our net short and do we then have to buy more gas production in order to support the… provide the fuel hedge effectively and to an extent the answer is yes, over time, but when we look at our overall gas load that's unlikely to be that material a driver.

I think your third question was around have assets… We said a year ago or 18 months ago we have to be patient because actually gas prices have fallen and only buy for value. That remains the case, we don't, as I said earlier, we're not doing this against the clock, if we can see value, if we can see the opportunities of generating the necessary sort of short term earnings, not just a long term value play then we will invest, but we're not just going to say okay, to use your words we've got to do something because at the end of the day we are very focused on delivering value for our shareholders and the returns have to compete with other returns across the Group.

Further question

So you only do it if the market economics are there, so potentially you would leave that electricity hedge…?

Answer: Sam Laidlaw

If we couldn't… If we couldn't close it for value, yes, because we would have concluded that actually the risk to that hedge being open was actually a better risk to take than the risk of deploying a lot of capital when the market didn't support it.

Answer: Nick Luff

It is worth adding, Mark, that the short term return profile's very different if you've got capacity payments of course, so if you're looking at Texas it is undoubtedly difficult to find assets that are going to give you any sort of short term return. If you go out to PJM where you've got capacity payments the financial profile's quite different.

Sam Laidlaw

And that is an important distinction. In PJM in many years the opportunities, over half the revenue actually comes through the capacity payments.

Mark Freshney

Thank you.

Sam Laidlaw

So I think with that, I suggest we all take a break now. Thank you very much for your patience and thank you for some great questions and many thanks for those who joined us on the webcast, I think we leave you now, but thank you very much for your interest.