Centrica Interim results Presentation for period ended 30 June 2008

31 July 2008
Presentation Transcript

Roger Carr - Chairman

Good morning ladies and gentlemen. I know it is a pretty busy day for results today, but welcome to the Centrica Interim Results Presentation. As usual, Nick will take you through the financial performance and Sam will then review this performance in the context of both current trading conditions and future strategic developments.

Clearly we are in an unprecedented period of soaring world wide energy costs which show little sign of material reversal in the near future and this has necessitated the implementation of the price increases we announced yesterday.

Sam and the team have worked hard to mitigate the impact of higher wholesale costs on customers by driving down the costs that are within our control, and equally Phil Bentley in British Gas has made major strides in improving customer service and in developing innovative propositions to enable customers to protect themselves against rising energy prices. Nevertheless these price increases remain essential to the delivery of a reasonable and necessary profit margin to sustain the current and future health of the business and our ability to invest in long term supply security.

Upstream we have benefited from higher prices in Centrica Energy and, as you know, much of the profit is absorbed by higher Petroleum Revenue Tax. British Gas Services and British Gas Business have performed well, with strong growth and good returns. Our North American business, in the face of much stiffer economic headwinds, has produced a solid result.

In parallel, our patience and the application of financial discipline and determination has enabled us to strengthen our asset base on attractive terms. This will continue to be the key focus of the business as we seek to further improve the hedge within our business model.

In considering dividends, we have maintained our stated policy by setting the interim dividend at 30% of the 2007 full year dividend. The growth in the interim dividend is simply a reflection of last year's unusually high full year results and the full year dividend for 2008 will be in line with our policy of real growth, but in the context of the more normal performance levels.

Last week we announced our decision to exercise our right to pre-emption with GdF in order to acquire the controlling interest in SPE. This strengthens our European presence with both an attractive business to Centrica and a prized asset in the

European energy market. This will provide both critical mass in the short term and the prospect of material value enhancement in the future.

Looking forward, the scale of the business and investments will change the shape of our balance sheet. We will however continue to target an appropriate credit rating and retain sufficient financial strength to enable us to take advantage of upstream opportunities when available and maintain our stated investment programme.

In recent weeks, we have been fortunate to recruit Mark Hanafin, who is here today from Shell, who will replace Jake on the Board following his decision to retire. This move will complete the changes at a senior level and I am confident that the team under Sam's leadership will continue to build on the strong foundations that have been created.

Finally, we have made no secret of our interest in improving our hedge by having a greater involvement in nuclear power on the right terms. In recent weeks there has been much press speculation on the potential nature of our involvement and I hope you will understand that there is really nothing more we can say on this topic today.

I will now hand over to Nick. Thank you.

Nick Luff - Group Finance Director

Thank you Roger. Good morning everyone. Let me start with the commodity price picture that forms the background for these results. Obviously we have seen some fairly dramatic changes in commodity prices over the last year or so. In the first half in particular the average Month Ahead gas price was about 55 pence, more than double the equivalent figure for the first half of '07. As you can see on the chart oil prices have now dragged up forward gas prices such that forward prices for next winter are now around 90 pence a therm and that is of course why we had to increase retail prices yesterday.

So with that background, let me turn to the results themselves. Obviously the comparison with the exceptional figures of the first half of 2007 is a pretty tough one. Nevertheless these are a good set of results in absolute terms. Just to pick out some highlights for you. Revenue £10 billion, up some 17% reflecting the higher gas and power prices. Operating profit was down, but still came in at just under £1 billion. I will come back to the divisional breakdown of that in a second, but as you know there has been a significant shift to profit from the downstream to the upstream. And with upstream being so heavily taxed of course, that has pushed up the overall Group tax rate which has come in at 58%. With that heavy tax charge, that left us with earnings of just over £400 million which translates to 11.3 pence per share.

The interim dividend, as Roger said, we have stuck to our formulaic approach, 30% of last year's full year dividend, making it 3.9 pence a share.

So for the divisional breakdown and here you can see immediately the shift from downstream to upstream with BGR down and CE up. For BGR, the dynamic was all about how rising revenue interacted with rising commodity costs. Average selling prices in the first half were actually only up a little, with the 15% tariff increase that we put through in January offsetting the 20% decrease in tariffs that we put through over March and April last year. However, we did have more normal weather conditions in the first half, meaning it was colder than last year, which obviously increased

consumption, particularly gas consumption and that higher consumption fed through to higher revenue.

Against that of course, commodity costs were up substantially on a unit basis, up some 30% and that is what has led to the significant reduction in operating profit, albeit down from what we recognised at the time was an unsustainable level.

We did continue to make progress on reducing operating costs within BGR. We are on track to deliver the £60 million of savings that we are targeting for the year as a whole. Other costs however, if you see on the chart, other costs, transmission costs in particular did rise. These of course are costs that are set by the Regulator and suffered by all suppliers, so whilst we don't welcome them, and of course it feeds through into retail tariff, it doesn't necessarily affect our relative competitive position.

That is BGR. The other side of the coin is CE, of course, with profits coming in at over half a billion. However, within that there were quite a few swings and just to take you through some of the detail. Obviously gas production profits were up substantially. Not only did the average selling price more than double, but production volumes were up by about a third with Morecambe running pretty much flat out, and the other fields also performing well.

Against that, as you can see in the bottom left, the I&C contracts moved back into loss, in fact into quite a substantial loss. Whilst the selling prices on the I&C contracts did benefit from some indexation, the fact is that the input prices went up by much more, which put them back in a loss position and of course customers, where they have optionality over how much volume they take, have been maximising volumes and that also hurt us.

If you apply current forward prices for the rest of this year, the loss on these contracts in the second half will be even higher than the first half, and if current forward prices for next year remain, and actual prices are in line with that, the losses will continue through into 2009. Relief does start to come in 2010 when some of the more significant contracts come to an end, and as you can see from the chart on the bottom right, by 2011 the volumes are minimal.

And finally within CE if you go into the top right power generation. Although not that material to the overall result for CE, the result here was a bit disappointing. Spark spreads have actually been significantly higher than they were in the first half of '07, but the benefit to our power generation business has been somewhat delayed as we hedged out the position when spark spreads were somewhat lower. In addition, we did suffer an outage at the Humber power station, which is our largest station, which was out for a maintenance outage, but took longer to come back from that than we were expecting and that is what has led to the reduction in generation and volumes that you can see on the top right.

Turning to the rest of the Group and starting with BGB, here the reported result was up £7 million to £55 million, but that of course does reflect the favourable historical electricity procurement contract that I have talked about in the past. If you strip that out the underlying improvement in performance of BGB was £20 million. So that was a very good result from them indeed.

Storage, as expected, the result here came in a bit lower reflecting the lower SBU prices for the 2007/08 gas year. However, of course, it remains the case that Centrica Storage is making very good returns on the investment we have made in that business.

British Gas Services is having a very strong year. We continue to see good growth in the newer products, plumbing and drains, home electrical cover and that drove the revenue growth of about 8%. In addition, we continue to expand margins. Margins in the first half came in just under 13% and that came from a combination of changing product mix and also continued cost efficiencies. That combination of higher revenue and expanded margins fed through to very strong operating profit performance, up 35% to £85 million.

In contrast, Direct Energy faced more difficult market conditions, rising commodity prices squeezed retail margins for our tariff based customers, and also the slowing US economy did have some impact. As a result operating profit was down on the first half of '07, although it was an improvement on the second half of '07 and we do expect to see that improving trend to continue as we pass through the increasing commodity costs through into the tariff base.

There was a similar dynamic in Europe, where Oxxio in particular struggled as retail tariffs did not keep pace with the rising commodity prices. However going forwards, of course, this segment is going to look quite different. We now have, as Roger mentioned, SPE at 51% so that will be consolidated, and SPE itself will of course benefit from the Pax Electrica 2 contract, so you will see more earnings coming out of our European segment.

Overall then, operating profit just under £1 billion, down from £1.2 billion last time around, with the main drivers being the lower profit from BGR, after last year's exceptional numbers, offset partially by the better result from CE.

So that is the income statement, let me turn the cashflow. This perhaps requires a little bit of explanation. What is going on here is some quite interesting swings. It starts off reasonably simply as you see with EBITDA £1.3 billion, which was just down in line with the reduction in operating profit. However, after that it does start to get a bit more complicated. We saw a half a billion pound working capital outflow. Partly that was seasonal, our usual seasonality we have in the business, but it also reflects the increase in tariffs which increases our debtors and hence our working capital, particularly in BGR. However, offsetting that, as you see there was a billion inflow from margin cash calls. That is margin cashflows in the commodity hedging contracts that we have entered into, and obviously as the commodity prices have risen those contracts have moved heavily into the money, which has generated that margin cash.

Capex as you can see was £550 million, and I will give you a break down of that in a second. But despite that investment in the business, overall net cash inflow was still over half a billion, leaving us with debt at the end of June of less than £300 million. However, just to caveat on that number, it does reflect the fact that we are holding a billion pounds of margin cash as at the end of June. Of course that will run off over time. It is difficult to forecast the margin cash balance as it depends on commodity price increases or decreases. But what I can tell you is that the contracts to which the current margin cash balance relates, pretty much all run off over the next 18 months or so.

As promised, here is the break down of the capex figure, and also a look forward to our investment plans for the rest of the year. As you know, 2008 is a reasonably heavy year for investment, both organic and acquisition. We continue to invest in our gas fields, as you can see, including the ones that we acquired under the Newfield transaction last year. And in power, we have got the Langage gas fired power station

that we are continuing to build which is a significant investment, as is the Lynn and Inner Dowsing wind farms which we are investing in this year as well.

On the acquisition front, the first half included Rockyview Energy and TransGlobe, the two Canadian upstream deals. It includes Sojitz, the North Sea Gas deal, and it also includes Strategic Energy which was the US C&I acquisition that we completed in June. And for the second half of course we have already got lined up acquisitions in Heimdal, the Norwegian gas deal, £190 million investment there, and of course the expenditure on the 25 ½% of SPE to take us to 51%. That will use up to €620 million.

So in summary, a good set of results against the challenges of rising commodity prices, the main dynamic being the increase in results from CE offsetting lower results from BGR, but we also had some good performances from the growth businesses. The I&C contracts did hold us back somewhat and perhaps masked the structural hedge benefit that we do get out of our existing upstream assets. But looking forwards the tariff increase that we put through yesterday will enable us to make reasonable margins in BGR in the second half, and whilst obviously there is still a number of variables, the weather, how our commodity prices move from here, at this stage, assuming normal weather and current forward prices, we are comfortable with current expectations for the year as a whole.

And with that I will hand you over to Sam.

Chief Executive's Review
Sam Laidlaw - Chief Executive

Thank you very much Nick and good morning everybody. As you know it has been a very tough six months of the year. Global energy prices, as Roger said, have moved up sharply and wholesale UK gas prices have followed to long term levels that frankly we simply haven't seen before. But we are countering this by staying focused on the four strategic priorities that I set out at the beginning of last year. First, to transform British Gas, second to sharpen up the organisation and reduce costs, third to reduce risk through increased integration and finally to build on our growth platforms. I would like to touch on each of these in turn.

Firstly, the transformation of British Gas. We are here making excellent progress. We will continue to improve the customer perception, and the competitive positioning is also improving. The cost structure too is coming down. I think we have come a long way in the last twelve months, and let me first look at customer service. We showed you some statistics back in February and here you can see that we have really moved the game on. Complaints to Energywatch continue to fall. In June this year we had some 250 complaints compared to over 4,000 in April last year. and this is out of a total of 1½ million customer contacts and calls during the month, or less than one in 5,000. Of course we are not going to stop here, but this is a big step forward and whilst achieving the service level improvements, we have continued to reduce the controllable operating costs in British Gas. In the first half we reduced costs by some £35 million and we are on track to take out £60 million for the full year. As promised, that is over £200 million or 20% of the cost base over the last two years.

Throughout the first half, wholesale prices for this winter have continued to move up sharply and remain as you know at around 90 pence per therm. At this level, the price increase that we announced yesterday was absolutely necessary to restore

margins. Increases clearly of this magnitude across the industry may have some impact on churn and on the size of our customer base in the short term, but we are investing to retain the customers and to fulfill our social obligations. Following a recent re-organisation of our sales effort, we have experienced higher account sales, our customer churn has been falling, and our better service and lower cost base will help to mitigate the impact of this price rise.

We are also on the front foot with our propositions and yesterday we launched a range of market leading products and bundles to protect our customer base. You will have seen some of the advertising materials outside in the hall as you arrived. We now give customers the opportunity to fix their prices out to September 2011. And this is on top of the 2.1 million customers we already have on fixed price products today. We also very importantly have held back on the price rise for our vulnerable customers. Our Essentials tariff will not increase until the end of this winter. We introduced a dual fuel discount for Pay As You Go customers, and we are offering a bundled proposition which allows customers to fix their prices and take advantage of discounted insulation. And we have revamped our online Energy Savers Report to make the advice that it offers much more usable. And for those customers on the tracker product, the price rise will be delayed until later in the year, due to its seasonality.

Our second priority is to sharpen up the organisation and reduce costs. We have the management team and the systems in place and we are continuing to take costs out, right across the Group. Even in the growth businesses we are reducing our core costs, while expanding in areas that drive future growth. We show here our like for like costs for the first half of 2008 against the first half of 2007. For ease of comparison we have removed those costs associated with acquisitions made in the first half of this year and those associated with one-off exploration spend. And you can see here that despite significant general inflationary pressures, and higher overall cost escalation in energy related services, we have actually reduced our operating cost base year-on-year. And we expect, on the same basis to hold costs flat for the full year.

Our third priority is to reduce risk through increased integration. Here we have also made good progress and created some valuable opportunities. Firstly in gas you will have seen earlier this month the recent acquisition of the Heimdal assets in the Norwegian sector of the North Sea. This brought an additional 165 bcf equivalent of reserves and gives us first gas production in the Norwegian sector, as well as some interesting development and exploration opportunities. This is a unique facility as the gas produced from Heimdal can be shipped directly to the UK via the St. Fergus facility from 2011 onwards. When you put this transaction together with the assets acquired in the Newfield and Sojitz deals over the last nine months, we will have invested or committed some £800 million and added around 500 bcf of reserves to the portfolio. That is some two years of production. A lot of those reserves are not yet developed but we are pushing ahead with turning probable and contingent reserves into proved producing reserves. We have a rig on location at the Grove Field and have commenced drilling and we brought forward the development plan for the Seven Seas Field which we now expect to be on stream by the end of 2009.

Following the Heimdal acquisition and the accelerated development programme I have reproduced here a chart which I first showed you back in February. This shows the current and projected cover we have against our downstream variable gas

demand. To complete the picture I have also included our equity wind positions and our long-term tolling contract with Drax. The development area on the chart includes assets where we have approved development plans and the hashed acquisitions area once again has the conservative assumption of only some hundred bcf per year. As you can see from this, including the Drax contract, by 2011 we reach 40% cover and even excluding this we are still over 35% hedged. We are also reducing gas price exposure by contracting for gas on a more diverse range of pricing mechanisms rather than all on monthly NBP Month Ahead. Recently we struck two new contracts and agreed an amendment to an existing one which over the medium term will move an additional 4 billion cubic metres of our annual gas procurement away from Month Ahead onto more diverse pricing indices.

And within this we have also achieved some additional winter shape. Gas storage is another effective way of hedging our gas price risk. You can see here that the UK is fundamentally short of gas storage. As a percentage of annual demand, the UK has around a tenth as much storage as Germany. And we are well behind all the main European countries. So storage is very important and an attractive investment option and offshore gas storage is the only way of making large steps forward. And we are the company with the knowledge and the expertise to compete here. Recently we announced that we are pursuing a project with partners in the Bains Field in the East Irish Sea near Morecambe. Bains is currently an operated gas field and in conjunction with GdF and First Oil we are commencing pre-development studies this year. This has the potential to store some 20 bcf of gas. We are also considering another storage opportunity in the UK Continental Shelf. This has the potential to be a much larger field, which could store up to 60 bcf of gas. Both of these fields could cycle the gas much faster than Rough. This is in itself very valuable as it will allow customers to move gas in and out much more often. This will provide us with a portfolio of assets which creates further value by enabling a broader range of storage products and giving us the ability to optimise across the fields.

At this point in time these projects are still in the very early engineering stage and they would require in total some £1½ billion of capital investment but they could be operational by 2012/13 winter.

Now wind is another area where we have been making good progress and developing a pipeline of opportunities. To meet EU commitments, the UK must source 15% of its energy requirements from renewable sources. The majority of the responsibility falls on power generation and offshore wind is the only way of making meaningful progress against this target. We already have a portfolio with five producing wind farms totaling around 380 megawatts, including Lynn and Inner Dowsing which commenced operation last quarter. We are pleased with the economics that we have experienced so far. Load factors have been higher than expected, averaging 30% onshore and 41% offshore. And we are pushing ahead on our pipeline of new wind developments. Planning is well advanced at Lincs, our 250 megawatt project, and we have begun the planning process for our two 500 megawatt farms at Docking Shoal and Race Bank.

And we have also begun to look at the options for bringing in outside finance to enable us to move ahead more rapidly here. Of course forward wind construction costs are rising. But as you can see here, from the picture of the project pipeline, so is the revenue stream. We have plotted on this chart the rising construction costs against the price of power and the ROCs which are generated. As you can see the early wind farms are very much in-the-money. For the larger future projects the financial commitment is substantial, with construction costs around £3 million per

megawatt. But the new ROC regime offers 1½ ROCs per megawatt hour and this should mean that the economics remain attractive.

Finally nuclear. Roger mentioned the sensitive nature of this topic earlier. We have made no secret of our desire to have an involvement in nuclear in the UK, and there is no doubting the quality of the proxy gas hedge that this could bring. Beyond that I think I can make no comment at this stage.

Now looking at our fourth priority, to build on our growth platforms, we have had some really strong performances here. As Nick mentioned earlier, British Gas Business had a very strong first half. We saw a combination of growth in customer numbers, growth in revenue and a reduction in the operating costs percentage. All of this led to growth in operating profit and rising operating margin. And we intend to go forward from here. Although we have consistently grown, we still have a very small share of a very large market. We have a strong customer base in each fuel to enable us to effectively cross sell our dual fuel proposition. And we are currently pursuing options in the business services market. This currently is a poorly served market, with no clear leader, and we expect to launch new propositions here very soon.

And it was another great six months for British Gas Services. Again on every measure, revenue, customers, efficiency and profit, we took a large step forward. And while delivering on the financials, we also maintained customer service in this very complex business. We also launched new products, for which the early sales statistics are very encouraging. And this month we began a trial with British Gas Energy, where the highest value energy customers get priority access to the service engineers for emergency call-outs. This should benefit both businesses. And the installation business, which will be key to our environmental positioning, grew both market share and profitability.

Now let's turn to North America. Conditions in the first half of the year have clearly been challenging. But we have weathered this well. The economic slowdown is biting, particularly in the US. New home sales are at their lowest level for 17 years. And the first half results were impacted by the rising commodity prices across all regions, including particularly intra-day spikes in power in Texas and by an outage towards the end of the period of our Bastrop power plant. But throughout all this, we returned to growth in our Mass Markets Energy retail business and we have raised consumer prices in Texas to offset the commodity increases and restore reasonable margins for the second half of the year. And we grew our customer base in the core care products and the Home Services business. In C&I, the acquisition of Strategic Energy makes us the third largest supplier across the US and after one off integration costs in the second half of this year, this sets us up very well for growth in 2009.

The upstream business in North America is also increasingly important. We acquired additional gas assets through the acquisitions of Rockyview and TransGlobe and we increased gas production by over 20% in the period, to 111 million cubic feet a day. So I think we are very well placed going forward.

In Europe you will have seen our announcement on SPE last week. We exercised our right of pre-emption over GdF's 25½% share in the business and we now have a controlling 51% stake. SPE is the second largest generator and retailer in Belgium, with around 1½ million customers and 1.6 Gigawatts of diverse generation. And importantly under the Pax Electrica 2 agreement, SPE will receive beneficial power off-take of up to 535 megawatts from Belgian nuclear plant. This will greatly improve its competitive position in the retail market. The controlling stake also gives us real progress in Europe and increases the strategic options going forward.

So in summary, we delivered strong results in a very difficult commodity market. We made good progress across the Group. In British Gas we removed costs and further improved our customer service. Overall for the Group our cost reduction initiatives offset the growth and strong inflationary pressures so that year-on-year controllable costs will be flat. Upstream we have made real progress in gas, in storage and in the wind generation business. And our growth businesses have delivered well again with particularly strong performances from British Gas Business and British Gas Services. We still have some distance to go. Further integration remains a key priority, but I want to assure you that we will stay focused and disciplined in investing to deliver value for shareholders.

Thank you.

Roger Carr

Questions and Answers

Q1. Bobby Chada, Morgan Stanley

I have a couple of questions. First of all on your power plants. Across the fleet there have been quite a few outages this year. Does it reflect anything significant? I know you can get unplanned outages all the time, but do you think you need to invest more in the power station fleet, given how important it is as part of the integration? Secondly, I just wanted to ask a question about your view on how to control the business. When you bought SPE, originally, it was a 25% stake. As you thought about that, did you insist on having some operational control at SPE? I would just like to put that into context. And what does the extra 25% get you other, in terms of extra control? And then lastly on the mark-to-market, on the £1.1 billion of margin call, should we view that as the net present value of your in the money hedge position? Or is the in the money hedge position more than that and the margin call is just a sign of good faith from your counterparts? Thanks.

Answer: Sam Laidlaw

Well Bobby I will take the first two and Nick will take the margin call one. Firstly I think power performance, yes, I think it is fair to say we were disappointed with power station performance in the first six months of the year. We had two significant outages. One was a planned shut down at our Humber power plant. And actually when we were bringing the plant back on we had mechanical problems and I think these are actually vendor related problems, but I think we recognise as I think the rest of the industry does that a lot of the vendors are very stretched at the moment. But I think we are doing a lot to redesign our quality assurance programmes. I don't think, to answer your question, there is anything systemic in this. I think the fleet is certainly up to the usage we are putting it through. In the US as I mentioned we had an outage of our Bastrop plant. We were actually able to bring that online within a week. So I think actually the team did a very good job there, but unfortunately in both cases, that coincided with periods of high spark spreads. But we have redesigned the organisation and the processes and I don't think there is anything systemic with the quality of the fleet. And we certainly expect in both cases to have a stronger second half. As we go forward of course, we will also be benefiting from, the fleet will be benefiting from Langage and additional capacity.

On the second question on SPE, when we made our investment we made our investment through Segebel which is the holding company. 50% owned by ourselves and 50% owned by GdF and together that business had a 51% controlling interest in SPE. What we have done is acquired the GdF interest in Segebel which therefore gives us the same rights that that joint company had. It does therefore give us greater control of SPE than we have had previously. Now clearly we have other municipalities and other shareholders in there, but we would expect to be able to extract greater synergies with the rest of our business, but also I think insure that we have more rigorous management of that business than has been the case with multiple shareholders.

Further question
Is it right then to think when you made the initial investment you had a level of control which perhaps wasn't perfect, but was more than a passive investment?

Answer
We had Board representation, more than passive investment, but certainly not the level of control over the business that we will have now. And I think it was always, we always recognised that that was a sub-optimal structure.

Further question
So in future investment decisions you would expect at a minimum Board representation, if you make any investment in any asset that you don't fully control?

Answer
Yeah, I mean in future investment decisions we will, on Belgium as 51%, we will clearly you know have the majority sharing which is significant. And procurement decisions for power and procurement decisions for gas and trading positions all of which are important.

Answer: Nick Luff
The margin cash question. Not all of our hedging contracts have margining arrangements in, so we don't margin with all counterparties. If you look in the notes you will see that actually in the balance sheet totally there is £2.5 billion net mark-to-market in the money contracts. However, even that, under the vagaries of IAS39 is only a subset and we have various so called own use contracts that don't get mark-to-market, the value of the reserves in Morecambe don't get mark-to-market. So even that you have to be a little bit careful with. But that gives you a feel for the scale of it.

Q2. Ajay Patel – UBS
Two questions if I can. Firstly on SPE. The Pax Electrica 2 agreement, what is the sustainability of that off-take? Is it a three year contract? Is it longer? And what proportion of the profits that you were indicating at the time of acquisition does that off-take agreement take up? And the second question I had was looking to the second half of the year for gas production, how should I be viewing volumes? Should I be assuming flat on volumes half-on-half for the second half or could we see some of the strong performance you have seen in the first half roll over to the second half? Thanks.

Answer: Sam Laidlaw
In terms of Pax Electrica 2, there are really two components to it. There is basically a virtual equity component for 250 megawatts, and that is a long life contract, you are talking 17 years and then there is an additional discounted power contract for 285 megawatts. So the way you need to think about this is we think approximately half of

the value, or in other words, an addition of approximately 100% of the EBITDA will come from, it will double the EBITDA in this business.

Further answer: Nick Luff

The only thing to add to that is that because of the way you have to account for the fair value accounting on the acquisition, the value from an accounting point of view gets lost in depreciation amortisation. So you know that is what happens to EBITDA but unfortunately not that much of it gets through to the bottom line. Obviously we benefit in cash terms, but not that much in earnings terms. On gas production, the second half won't be as strong as the first half, Morecambe has been out on routine maintenance outage for July and a number of other fields just naturally are declining. So I think generally and there is a consensus of about 2.4 billion therms of production for the full year, perhaps a bit more than that, but around that level and we are still comfortable with that.

Q3. Colin Pollock – Credit Suisse

I have got three questions if I may. The first one is to the fixed price tariff offering. Is this sort of calling the top of the gas market in terms of the wholesale price? Is there any limit to the number of customers that can take the offer up? And what kind of take up rate would you expect to see on that product? The second question relates to storage. The SBU price obviously came off in these results. Do you think at that level of SBU price is reflective of the future volatility or in other words is that roughly where it should turn now going forward? And the third question is on power generation. I think it is fair to say that it is not fully reflecting market spark spreads yet on the CCGTs. Can you give us some indication when you think that business will reflect spreads and also what load factors to expect going forward? Thanks very much.

Answer: Sam Laidlaw

Well I think your first question was, the fixed price offer that we announced yesterday is for a three year offer until September 2011. It is a low premium offer. That is in contrast for instance to the EDF one that was announced last week at 5%, so it is actually less expensive on the dual fuel than the EDF offer. You know it is for customers to clearly decide whether they want to take away the risk and lock in. We hope they do. We believe that actually we already have two million customers on fixed price offers and we would like to have more on it and we certainly have the capacity with the programme that we have put in place and the product to sell a significant number of customers that fixed price product. If we do that, clearly at the end of the day, is a different way of managing the structural hedge for the business too because effectively we lock in the margin for those customers and we would like to see more customers on it and I think customers who are concerned about rising energy bills will opt to choose it.

Further question

Is that to say that you will hedge the future gas for those customers as they lock in?

Answer: Sam Laidlaw

Yes what we do, yes. It is similar to an industrial or commercial BGB customer or is it similar to what we do in North America with our customer base.

Answer: Phil Bentley

Just one thing to add to that as well. I mean yesterday at the call centres we had calls to sell of 16%, which is levels we have never seen before, they are normally around 3-4% calls to conversion. So a lot of customers have been locking in. We had

Scottish and Southern customers coming in to long term deals because it is the longest out there. That is the first point.

The second point is that it is great for loyalty. We had a 2008 fixed price product that customers had entered into in 2005, and we rolled them into a new fixed price contract, 95% rolled over and at a much higher levels clearly. So for us it is a great way of building in loyalty to the customer base.

Further Answer: Nick Luff

Colin, your second question, regarding SBU pricing. Obviously the two things that drive the value of storage are the summer/winter differential and volatility and clearly as you said, the summer/winter differentials come down significantly. I don't think that is guaranteed to continue, it could clearly open up again and I think storage could become more valuable again just from that intrinsic spread. And also volatility has probably gone up and I think, as Sam showed in his presentation, the UK is structurally short of storage as we move to importing far more. So I think over the longer term, I think we are still very positive about the prospects for that business.

And on power generation, you asked about load factors. Load factors in the first half are about 65%. Obviously partly affected by the outage at Humber. So we can do a bit better than that and when Langage comes on which is of course a much more efficient station, we would expect that to be running more. And then obviously depending on spark spreads and how they evolve, but we can do better than that. And certainly from 2009 we would expect the power generation business to be doing a lot better. It will have Langage for much of the year. It will have the wind farms for the whole of the year, the Inner Dowsing Wind Farm for the whole of the year. And as Sam's presentation showed, the existing wind farms are, the economics look very attractive as you bring those in.

Q4. John Musk – Lehman Brothers

Can I ask a question on Home Services and really just to get an understanding of how that may be affected by an economic downturn. Is this a business where you are worried about what might happen to future sales or not?

Answer: Chris Weston

We have certainly seen an impact of the downturn in the economy starting after Christmas, but we have seen, despite that, strong growth mainly in what we call the secondary products. So electrical services, plumbing and drains. I think we have seen 16 and 10% growth there which is pretty strong. It has had a slightly larger impact on installations as you can imagine. That is a larger spend item for consumers, but that business now, which was loss making two years ago, is now generating a good net margin. So it hasn't been a dramatic impact on that business. We have also started to introduce some really good new products, home emergency cover and water supply pipe and TimeChoice. So giving our customers a more precise time window of when we will visit them and customers are prepared to pay for that. And those we launched in the first half of the year and we are seeing very good growth. So I hope we will have a good story around those for the end of the year.

Q5. Jamie Tunnicliffe – RBS

Just comment on, asked if you could make a comment on the storage prospects for 60 bcf's that you said was a potential. What sort of level and durations of the intrinsic spread do you think you would need to justify? I think you said something like 1.5 billion potential Capex. I just wanted to check if you would give some indication of

the, maybe what part cushion gas would be? Is it something you are willing to comment on?

Answer: Nick Luff
Yeah, obviously this is a very early stage and we are studying those projects so we are not going to give out too much commercially sensitive information when we are pursuing the new projects. But clearly the cushioned gas has become significantly more expensive at current prices and that does affect the economics of storage. But we still think these projects will work based on our current expectations for forward prices with some wider spreads and volatility.

Q6. Edmund Reid – Cazenove
Two questions. Firstly in your statement you talk about a tax issue, I think £70 million tax issue, from changed to upstream taxation and I just wondered if you could give some more details on that? I didn't fully understand it. And then the second thing was just on the pricing differential that you announced yesterday between gas and electricity. You know it is fairly unusual from memory for there to be that degree of pricing differential and I was just wondering if you could talk us through your thinking on that?

Answer: Nick Luff
Yeah, there is a potential credit, just to be clear. It is a favourable potential for us. The fact is they are clarifying some of the rules around the deductibility of decommissioning costs in fields that pay PRT and how you can carry those back. And assuming that gets enacted then at the moment, in doing our deferred tax calculations, we have to assume that we aren't certain of the decommissioning costs, we won't get tax relief. If that comes through, then we assume that we will and therefore, the cash tax is years and years out, but there would be a deferred tax, and hence an accounting benefit in the short term

Further question:
Is that in your current guidance forecast?

Answer: Nick Luff
No, that is the potential upside against the current guidance.

Further question:
And would it be the £17 million that you talk about?

Answer: Nick Luff
Yeah, it covers exactly the rules say and what we need to then analyse exactly what decommissioning costs we can then offset and work that through the accounting etc. But that is an order of magnitude potential.

Further Answer:
And on your second question, which was around the differential pricing and clearly there is a big difference between the 35% on gas and the 9% on electricity. The rationale for this is very clear. Firstly gas prices have actually gone up faster than electricity prices. But I think fundamentally we have also recognised that returns on the gas side of our business have been low and have been loss making and we need to correct that. And what has been happening is the number of our competitors, particularly those with coal generation and free carbon credits have been cross subsidising into the gas business and you know, and the margins in that business have become very poor and we are fighting back and getting a respectable return in that business and taking them on in the electricity business.

Q8. Andrew Mead - Goldman Sachs

Just two questions. One on the UK power generation business. Could you explain a bit about how you actually do the hedge there? You clearly say you hedged in a low sparks point at the moment and if things stay as they are, when that will come through potentially in numbers and why you sell so much forward at the moment? And my second question was on the British Gas Residential fixed tariffs. Can you remind me, when you cut tariffs last year, did you see or did you allow any of the customers on fixed tariffs to come off them?

Answer: Nick Luff

On the first one, I mean this goes back. The power generation segment, of course we only separate out for the first time last year and when we did that separation, we did some initial at market at the time, trades between the upstream and the downstream, as any power generation business standing on its own would do, to put in place some certainty over its income. But at the time spark spreads were quite low and they will roll off through the back end of this year and into next year. But the benefits in the BGR cost of electricity. But obviously the power generation segment itself suffers as a result.

Further Answer: Phil Bentley

On the fixed price offers, there are exit penalties in all the products. In reality customers tend not to switch out of them and obviously it is just as well they didn't given that prices have gone up since then. So we haven't seen that as a factor at all.

Q8. Nathalie Cassali – JP Morgan

Can you talk a little bit more about the outlook in the US for wholesale generation, given the recent concerns, particularly on the Texas market? And also maybe give some colour on the bad debts issues? And secondly, I just wanted to ask on the UK, how confident are you that you can keep the full benefit of the price increases that you have put through yesterday without facing any type of government intervention? Thank you.

Answer: Deryk King

I see the outlook for power generation in the US being strong in most regions. Particularly where gas is on the margin, we are seeing high gas prices feeding through a power generation for prices. But we are seeing pretty firm spark spreads as well. So in Texas I would expect to see spark spreads pretty robust going forwards. As in the UK, just relating to a question that was asked earlier, we hedge our spark spreads forward as well, usually between 12-18 months and so our spark spreads in Texas this year are somewhat below market and again we will see a little bit of a balance next year when those hedges unwind.

I think the second question was relating to bad debt. Bad debt is still a difficult issue, particularly with US housing recession that we have. Very large proportion, much larger than usual proportion of UK homes are in what we call negative equity over here. And a lot of customers are just walking away from their houses and mortgages and when they do that of course they leave the bad debt on all their utilities and telephone behind them. So we have seen an impact of that. Despite that our bad debts in Texas are 35% down this year on last year to date.

Further answer: Sam Laidlaw

And I think your second question was, are we confident that we will be able to keep the benefit of the 35% on gas and 9% on electricity with the price increases? I mean I think the reality is, and obviously we have been engaged with government on a number of programmes such as our Essentials tariff to help the fuel poor and I think

the reality is that they understand that we have, we are facing a £2 billion increase in our commodity costs and that the margins in this business have been in the 3-4% range for the last five years and therefore this is not an opportunity for windfall profits. They also recognise that we are already paying a 60% or 58% marginal tax rate as you saw from Nick's presentation and therefore I think the answer is that we need to see the results of the Ofgem Inquiry which comes out in September. But I think the case has been very well made that if we are going to invest in the sort of Power generation fleet we need going forward that is going to be low carbon, that is going to be a massive investment for the country and this would be very damaging to investor confidence if there was to be any form of windfall profits tax. I think that message is understood, but you can never be sure. You know I think from our point, our actual exposure to windfall profits tax around carbon because we have a low carbon fleet is relatively small, relative to the competitors. So it is less of an issue for us than it might be for others.

Q9: Bobby Chada - Morgan Stanley

Obviously no one is really focusing on any discussions for a long term gas contract, given some of the other high profile things in the press. But are you still having those discussions and how would you say the attitude of potential counterparts has moved over the last twelve months with the high prices that they might be able to sell LNG into Asia compared to where they were when you joined the company and first brought this up?

Answer: Sam Laidlaw

That is a very good question Bobby, and yes we are still very much engaged in looking at the new long term supply contracts. I think it is fair to say that a year ago when we had very soft prices in the UK, some of the Middle East and Russian suppliers and those with LNG were actually concerned about the UK market because of the very soft prices. And of course when you look forward at wholesale prices for this winter, you know, they compare with Asian prices and therefore what we are seeing is actually those suppliers coming back to the table which is good.

Q10. Iain Turner – Deutsche Bank

Can I just go back to the SPE acquisition, it looks to me there isn't a huge amount of information available in SPE, but if you look at what you made from your stake last year, like you made a million pounds post tax, how do you justify the price of what you paid in the preemption? What do the economics look like? I am obviously missing something.

Answer: Sam Laidlaw

It is a fair question. Let me help. I think the £1 million you are probably looking at a European number which includes some other businesses and certainly if you look at the first six months of this year as we indicated in our statement, we had some challenges in our Oxxio business where the wholesale price ran up very fast. And therefore that was a loss making business. So that partly masks SPE which did better than that. But the real factor and driver as we indicated earlier is that actually we think that this business will double its cashflow and EBITDA as a result of the Pax Electrica 2 accord which will be conditional on our taking over 51%. So we think there is a significant opportunity there. As Nick indicated earlier on, not all of that is going to flow through to earnings, because of the fair value accounting but nevertheless from a cashflow point of view, it is an attractive asset.

Further answer: Nick Luff

Ian you might have seen we have given guidance for EBITDA of €240 million, so the price should be compared to that number rather than the historic after tax profits. And

when you are looking at what was in our figures previously because it was an associate, we took the after tax after interest number rather than the EBIT number. So the comparison is quite difficult to make. EBITDA of €240 million is including the benefit of Pax Electrica.

End of Presentation