Centrica – 2005 Preliminary Announcement

Thursday 23rd February 2006
09:30 UK Time

Roger Carr

Good morning ladies and gentlemen and welcome to the Centrica results presentation. As usual, the main presentations will be given by Sir Roy and Phil and afterwards we'll take questions ably supported by the key members of team here today Jake, Derek, Mark and Chris.

But first I would like to share with my own perspective on the business and the current challenges.

Our financial performance in 2005 was good and it was a tribute to the executive team. Clearly we are in a period of considerable turbulence in the global energy market with unprecedented wholesale cost escalation, rising world demand and industry consolidation in Europe and North America.

Faced with these external uncertainties we have channelled our efforts into those areas we are able to directly influence, bringing to bear the benefits of disciplined management and focus.

We've concentrated on 6 key areas: Specifically we have undertaken rigorous cost reduction across the Group, invested in proactive marketing to strengthen customer loyalty, committed to positive price management to sustain profitability and strengthened management focus on building growth in our service businesses and our energy businesses at home and abroad.

Throughout we have maintained absolute financial discipline in acquisition and capital investment and improved our strategic focus through disposals. Whilst much progress has been made on many fronts the high commodity prices have limited our ability to purchase material quantities of equity gas at value creative price levels. Our ambitions to strengthen our hedge remain unchanged, but you can be assured that our patience will not be exhausted and we will be firm in our resolve to keep shareholder value at the top of the agenda.

Now all of this drive for performance improvement has been led by Sir Roy with the same enthusiasm and commitment as he has shown throughout his tenure in building Centrica's success over the last nine years, and I would like to take the opportunity personally to thank him for his continued dedication and support which I know will extend through to the last day in the role.

Now with succession in mind, I confirm that we have, in parallel, conducted a thorough search for Roy's replacement and I'm please to report that we remain on track to finalise our selection by the end of the first quarter, with a view to the successful candidate taking up the reins at the half year.

Looking forward, market conditions continue to be challenging:- There's no real sign of a fall in wholesale costs. We have increased working capital requirements to support higher price levels and tax changes and there are continued competitive pressures both at home and abroad. Together with the potential impact of our retail price increase on our cash profile and the recent volatility in our share price, these factors have caused us to take the prudent move of pausing in the share buy back program until calmer and more predictable conditions prevail. I emphasise that income shareholders remains a priority. The board remain committed to the principle of capital discipline and we'll monitor the position with a view to restarting the program at the appropriate time.

Finally, I believe that the vigorous management action that we have already taken and the determination of the team to deliver further improvement will establish a sound platform on which new leadership and established board policy will combine to build a strong future. I'll now hand over to Phil to review the numbers.

Phil Bentley

Thank you Roger. Good morning ladies and gentlemen. 2005 has perhaps been our toughest ever year with the UK experiencing its highest absolute year on year increases in energy costs. Rising in gas by 68% and electricity by 49% and against this backdrop I'm pleased to be able to present another year of record operating profits and earnings per share for Centrica.

Let's quickly look at the summary numbers. Turnover rose by 18% to 13.4 billion primarily due to the continued growth in our North American businesses, now turning over 3.5 billion pounds. Operating profit from continuing operations was up 11% at 1.5 billion, however, earnings were down 4% at 661million as our effective tax rate rose 9 percentage points to 52% a mix effect of greater upstream profits incurring a higher taxation charge and higher PRT up 81 million to 373 million. But even on lower earnings EPS rose to 18.2 pence per share with the positive effects of the 04 share consolidation and the share buy back program reducing average shares outstanding by 12%, and still we continued to generate over 1 billion pounds of operating cash flow from the business. And our 22% increase in full year dividend is an indication of our continued confidence in the business over the medium term.

So let's look at a little bit more detail. Here you can see the segmental breakdown of operating profit. The overall 11% increase in Group EBIT is due to the fact that most parts of the company are performing well with strong performance results in upstream, in Storage, in British Gas Services and in North America. In fact only British Gas Residential Energy saw lower profits year on year due of course, to the rising wholesale markets. Operating profit here was down by 63% to only 90million pounds and I'll take you through the detail drivers of this now.

The cost of supplying energy rose by 824 million. Our WACOG was up some 33% and our WACOE up 30% and our decision not to recover the whole impact immediately, meant that price rises brought in only 726 million. The weighted average selling price of gas was up only 15% and of electricity up only 12%. Customer numbers were on average 850,000 lower and reduced the result by some 61 million. Lower levels of consumption, primarily a factor of the weather patterns around the shoulder months when customers turn off and turn on their central heating systems, reduced profits a further 107 million. A further negative during 05 was the increase of 24million in our energy efficiency commitment, which totalled a 112 million in the year.

On the self help side of the numbers you can see the benefits of the transformation program in British Gas coming through in the significant reductions in operating costs- some 138 million saved.

Now I'd expect the 06 operating costs to remain about 05 levels- as further efficiencies are temporarily offset by staff back filling costs and the peak of our billing systems dual running costs.

Looking forward to 2007 we'll see another substantial downward shift of at least 70 million, as we turn off legacy systems and see the full year benefit of outsourcing our back office processes.

Now turning to the upstream business in the UK. The 29% reduction in production volumes at Morecambe, though in line with our previous guidance, had a negative impact of some 232 million. Note though that around one third of this reduction was due to our decision to shuts in the field at times when the market price of gas had softened, particularly in October and early November last year. However the 48% rise in selling prices more than offset this, delivering an additional 316 million. But Centrica is more than just gas from Morecambe Bay the rest of the production portfolio where gas production levels rose by 24% delivered an upside of 157million, a total profit contribution of 210million pounds.

For guidance in 2006 we currently expect total gas production volumes to be down, but only by between 10 and 15 per cent.

Loses continue to rise on our industrial sales contract causing a negative year-on-year movement in the I & W segment of some 136million.

Although we did see a substantial fall in delivered volumes, we currently forecast the losses in this segment in 06 to be in excess of 300million. However, this will fall materially in 07 as out-of-the-money contracts start to expire. On the other hand our Accord trading business took advantage of the volatility in the market, with profits up by 25 million to 39 million in the year, while continuing to work within our existing value at risk limits.

Overall operating profit in Centrica Energy was up by 17% to 903million but post CT and PRT earnings actually were broadly flat.

Here you see the profile of the businesses beyond British Gas Residential and Centrica Energy. Together these growth businesses delivered around one third of the Groups operating profit in the year in total some 518 million, a year-on-year increase of over 50% and in post tax terms their contribution was over half the Groups earnings due to the lower average tax take here.

And I'd just like to highlight a couple of points:
Firstly, British Gas Services continue its growth under a new management team. Profits were up by over 50% due to top line growth of 9%, careful cost management and the Dynarod acquisition, which is going very well.

Home Services is an area where we believe there are real opportunities for growth in the future.

Centrica Storage posted an excellent result, further proof of the value of this acquisition. Standard bundle unit prices in the calendar year were up 41% at almost 35pence per SBU. An outstanding injection and withdrawal performance allowed 170million therms of additional space and 30million therms of native gas to be sold. A year-on-year profit uplift of an extra 31 million. In total this led to more than doubling of operating profits to 154 million that's more than half the price we paid for the asset in 2002.

With reference to last weeks announcement at Rough our current estimate is that the direct financial impact on Centric Storage in 2006 will not be material.

The North American business also increased its profits by 40% to 185million. It's geographic spread of operations providing a hedge against certain one-offs in the year. For example the spike in power input prices, following hurricane Katrina in Texas, was comfortably absorbed through our hedging strategy and our portfolio diversification. Overall the key point here is that our financial performance in volatile energy markets is underpinned by these more stable, but growing business units.

Now tax is an area where the landscape has become more complex over the last year or so. IFRS has moved PRT to the tax line and the shift in earnings mix to upstream adds to our tax burden. The effective 2005 ETR was 52% and the effective tax rate in 2006 will be in the high 50s, in line with the guidance we gave in December last year.

Two pieces of information will help forecast beyond 06. Our underlying CT rate in 2005 was 33.5% in 06, under the current forecast earnings mix, this rises to around 40%. Secondly our current three-year forward PRT forecast is shown here with 08 PRT at about half the levels of 05. The lower PRT is a function of both lower production at South Morecambe and also lower forward prices. And note as well that in general the new upstream reserve now being added, do not incur any further PRT charge.

The 10% tax increase on gas production to 50% was disappointing, especially when consumers are facing rising energy bills and at face the 2006 impact is around 80 million pounds. However, we had already restructured some aspects our upstream operations in 05 and this may well provide a tax benefit which offsets most of this impact and I expect to confirm this accounting treatment at the time of our 06 interim results.

IFRS also changed the landscape for reported debt levels, and this is a number we monitor carefully as we place A high degree of importance on our credit rating. I've laid out here the IFRS net debt position at the end of the year around 1.1 billion which excludes the 532 million debt associated with the Canadian Water Heater Income Fund which is strictly none recourse to the Group. You'll see that our IFRS debt is primarily made up of the finance leases on the Humber and Spalding power stations of 828million and that our underlying market debt was only 232million at the end of the year. However, the rating agencies include our IS19 pensions deficit at 571million and operating lease commitment for our properties at 425 and therefore can ascribe a net debt level of over 2billion.

The other area I want to clarify is in interest payable. In 2005 interest payable was 145 million and you can see on the slide the association between the debt balances and their specific interest costs. A large portion of this interest will not increase, such as the 97 million of interest on the declining finance lease commitments, the consolidated interest payments on the Income Fund debt, and the non-cash interest on abandonment charges. Obviously though the cash interest expense of 27 million in 05 with the function of our true underlying debt. And with rising wholesale markets in the short term our working capital requirement will increase by up to 500 million pounds broadly half due to receipts from customers generally lagging our payments to wholesale energy providers and the balance, due to the outflow of cash from previous margin calls, for which contacted volumes are now being delivered.

Finally 2005 was another strong year for distributions to shareholders. We proposed to raise our final dividend by 21% to 7.4 pence per share, which would take our full year dividend up 22% to 10.5 pence per share. This equates to an IFRS payout ratio of 58%. As we flagged before our intention going forward is to grow dividend in real terms and therefore future dividend increases are likely to be more modest.

During 2005 we bought back 385 million pounds of our shares and have now spent over 611 million of our 1 billion pound program.

So in summary 2005 was a good year financially despite the challenges. While the residential energy business clearly suffered from high commodity prices, our upstream business provided a valuable offset. Given continued wholesale market volatility especially in 4Q making predictions of downstream margins with any certainty is extremely difficult at this time. But it is clear we will be shouldering some of the excess commodity cost burden in 2006. Offsetting this though, upstream profitability will once again be ahead year-on-year.

The performance of our growth businesses in 05 as I said was particularly encouraging generating over a third of the Groups EBIT. These businesses are less affected by wholesale markets and therefore I would expect their contribution, both in absolute and relative terms, to grow in 2006, and we'll maintain our commitment to single A rating.

As I said at the beginning 2005 was a challenging year, but it's clear already that 2006 will be even more so. However, we will focus on the self help of reducing costs, freeing up our cash, managing working capital carefully, and ensuring that the investments we make meet our stringent hurdle rates. In short the financial disciplines, which have supported us through 2005, will continue. With that let me hand over to Roy.

Sir Roy Gardner

Thanks Phil and good morning everyone. I'm going to cover what we delivered in 2005 and how 2006 is looking.

Now 2005 was a tough year for all of us but we successfully managed all of the issues within our control. As we talked about in September and as Roger said in his opening remarks, we've been driving through a number of initiatives to deliver our plans in 2005 and ensure the continued strength of the business platform. And I have been pushing through very hard particularly on cost, on product innovation, and also on growth. And despite the undoubted challenges, we delivered a very good year.

Financially as both Roger and Phil have said it was a good result. Strategically we further reinforced our focus on energy and related services with the sale of Onetel. And operationally we did what we said we'd do - we delivered on our 2005 agenda.

So let's look at our financial headline. Higher operating profit and earning per share up 1% - in a year when the financial challenges were immense. I believe that demonstrates the strength of our underlying business model. Across the Group our entire focus in now on energy and related services. We've built a higher level of vertical integration, which gave us a significant financial benefit in 2005. At an operating profit level our upstream business provided a valuable hedge to the downstream squeeze. And we also gained from the inbuilt flexibility of our portfolio

If we look outside the residential supply and Centrica Energy businesses, we delivered excellent growth from our other activities. As Phil has already said over one third of our profits came from these areas, and because of differential tax rates across the business at an earnings level it was closer to 50% of our overall Group result.

Let's look now at residential energy. In 2005 we were faced with an environment that was as difficult as it's ever been. Commodity prices were the highest since Centrica was formed. In gas, the pence per therm rise was more than in any other year. Our residential energy margin in 2005 was 1.5% which clearly we don't see as being acceptable in the long term.

So it's no surprise that for the first time Ofgem have used the suppliers last resort directions as several small energy suppliers have gone into administration. We are investing in infrastructure projects and in contracts that we firmly believe will put downward pressure on prices in the future. But unless industry margins are restored to an acceptable level it's difficult to see how this sort of investment can continue to be funded.

Although both we and our competitors have chosen to absorb a portion of the cost in the short term, it appears that rational pricing behaviour is a feature of the market. And higher customer bills have been inevitable across the industry. Wholesale prices look like remaining high through most of this year. In 2005 we paid 5 billion pounds to buy and supply gas and electricity to our residential customers. In 2006 we could pay over 1 billion pounds more just to buy the gas.

Now last week we announced a retail price rise. Clearly the decision to raise prices wasn't one we took lightly either in terms of timing or quantum. In making these decisions there are many factors to take into account and whilst there are inevitable judgments involved our decision is soundly based. We've taken a view on the forward curve, where we can continue to believe that gas prices will outturn lower than the current curve. We've looked at the dynamics of the market, in terms of competitor response, our operational ability to manage the impact of customer churn and our desire to protect our customers from a further price rise in 2006. And we've considered the need to manage margin in the short term within the context of longer-term value protection.

It's clear that British Gas Residential Energy must be returned to profitability in its own right to sustain the long-term reliability of our business model in the interests of both customers and shareholders.

In attempting to mitigate the impact of last week announcement we've built on what worked successfully for us last time. We've built a strong sales team.1,400 professional field sales advisors and both in-house and out-sourced tele-marketing capability. We've developed new propositions which were brought to market quickly- for example our 2010 fixed price contract sign up incentives, and bundled packages such as our "free evening and weekend calls" offer.

We've had high impact marketing activity and we've developed rapid and well-coordinated responses to our competitor's actions.

The impact of this activity in the second half 2005 was as good as we'd hoped. Record sales level and lower withdrawal notification. We actually delivered growth in our electricity base in the second half of the year and will virtually flat for the year as a whole. Whilst in gas, the rate of net loss had started to turn round by the end of the year.

And the good trends has continued into the early weeks of 2006. But clearly, it's far too early to assess the impact of last week's announcement.

Looking beyond prices, I am delighted with what Mark and his team have achieved over the past year. On the transformation program we hit another major milestone. Our first large-scale migration of customers to the new billing system took place as planned over the Christmas period. Two weeks ago we completed a second migration taking our total to over 2 million accounts and we're also now putting all customer acquisitions straight onto the new system. By the fourth quarter this year we expect to have moved all our customers onto the new platform and we will be able to start decommissioning our old systems.

In 2005 British Gas also made significant progress in reducing its cost base. Achieving over 130 million year-on-year reduction. We've embarked on a complete review and redesign of the end-to-end customer process, and this is enabling us to make serious inroads into our costs by closing offices and by moving work offshore.

Our operation in India is now up and running and over the next twelve months we'll be moving more of back office processes, though we will retain our call centre activity in the UK. The progress in British Gas has been supplemented by review of our corporate and support activities and these have now been restructured to reflect the narrower focus of the Group. Across the Group in the UK we've told staff that over 2,500 people are going to leaving the company by the end of this year.

As Phil mentioned earlier the systems implementation makes it unlikely that British Gas's operating costs will reduce this year. But we've committed to deliver a cost base in 2007 that's at least 180 million lower than it was in 2004. And I'm confident that we'll do better than that. We're aiming to be one of the lowest costs to serve suppliers and we have a clear road map to get us there.

Moving on to upstream, we're now a year and a half into our five-year investment program. Originally, we'd expected that our program would be front-loaded but in the current environment we've had only limited opportunities to invest prudently.

We are pleased with the assets we've bought and the action we're taking, and the plan we set out for you in July 2004 remains unchanged. We want to increase our gas hedge in the UK to at least 35%. We will look at opportunities both in the UKCS and further a field. And we'll include some investment in infrastructure in LNG and also a limited amount of exploration.

We want to increase our hedge in power we now have 4.3 gig a watts of installed capacity including Spalding which enables to lease around 57% our residential peak demand from our own portfolio. And we'd like this to higher around 65 to 75 per cent and we're also still interested in achieving some fuel diversity.

We have an obligation to source 15% of our electricity demand from renewables by 2015 and we're aiming to source around two thirds of that from our own generation. And internationally our aim remains to support our downstream businesses with an appropriate level of upstream assets. You will have seen that at the start of the month we announced the acquision of a third power station in Texas. The Paris Energy Centre and this brings our peak coverage to around 31% from our own plant.

In 2005, Jake and his team progressed a number of opportunities and in September we covered this area in some detail, so I'll just pick out a few points to highlight here. The Kerr McGee assets were an excellent purchase. The price met our financial hurdle rate based on our lower view of the curve and the assets have got a very attractive production and earnings profile.

In 2006 they'll offset over a third of the decline from Morecambe. Last week the production sharing contracts in Nigeria were signed and executed and the planning application has now been submitted for the redevelopment of the terminal at Canvey Island to take LNG.

We've acquired the remaining 40% of Humber Power giving us an additional 510 Megawatts of capacity. And having had an assurance that new build will receive some free carbon allocations, we've invited tenders for the development of another

Gigawatt of capacity at Langage and we'll make the decision later in the year on whether to proceed.

We're now delivering our first green electricity and construction is well advanced on our offshore wind farm at Barrow. Internationally, we acquired generation in Belgium through our SPE acquisition and I've already referred to the third power station in Texas.

Contractual positions are also an important part of our portfolio and I was delighted that in October we begin to take gas as planned under the five BCM a year contract with Statoil that we signed in 2002.

So some good progress. Moving forward we not looking to accelerate our investment program unless we can find opportunities that met our financial criteria, but our plans remain intact.

Phil has already talked about Centricas Storage but it's worth just mentioning again that this business delivered an outstanding result in 2005 both financially and operationally. We've spent 45 million on maintenance and enhanced capacity since we acquired the asset. The operational performance last year showed the benefit of that investment. Reflecting its forward value by the end of 2005 we'd fully sold out storage for 2006-7. With a price of fixed units exceeding the selling price in previous years.

However, I should obviously mention the incident at Rough a week ago. There's always some element of risk with any offshore activity, but I can give you my assurance that our safety procedures and indeed our safety record at Rough are sound. I'm glad to say that the two people injured on the platform are now out of hospital and we are continuing to examine the installation and we will restore operations just as soon as it's safe to so. Rough is the UK's biggest storage facility by a long way and it is an important asset and we'll continue to invest in its maintenance and enhancement going forward.

One of the key elements of Centrica's strategy is to deliver growth outside of the residential energy supply and Centrica Energy business areas. In particular in British Gas Business, British Gas Services, North America and in the future continental Europe.

In 2005 Services and North America delivered particularly strong results. Looking at Services in 2005 it grew into a 1 billion pound turnover business. Delivered a 54% increase in operating profit and an 11% operating margin. Growth was right across the core product range. Organisational separation from energy although, with strong links maintained, is enabling the Service's team to focus on making sure that we identify and exploit the growth opportunities in the wider market.

We're aware that competiton is increasing and whilst our model remains unique we know we have to work hard to retain our advantage. We've expanded our product range in our central heating installations business, enabling us to target a broader section of the market. We're piloting new sales channels for example, working with a major home improvement chain to test the feasibility of selling our Home Care product in their stores. And our engineer deployment system will enable us to give a better customer experience as well as reducing costs.

Turning to North America which in 2005-delivered 58% growth in turnover to over 3.5 billion pounds a 40% increase in operating profits.

Once again Texas was a particularly strong story. The team managed the impact of two price to beat refilings- and achieved both reduced customer churn in our incumbent areas and growth in our organic base.

We launched our Services offer in Alberta and also Manitoba and we continue to grow in Ontario. We're increasingly using Home Services as a lead-in product for cross selling energy. We've established a firm foothold in business markets, with strong growth and entry to a number of new markets. We're also strengthening the business proposition by leveraging our services activity.

Derek has a strong and enthusiastic team with a clear strategy for growth and a good track record of execution.

In continental Europe we've begun the process of growing our position. Last year we acquired Oxio in Holland and a 25.5% stake in SPE in Belgium. And we are now trading gas and power on the TTF and APX exchanges in the Netherlands.
We're also considering a number of other opportunities including a potential tolling agreement in Holland and the possibility of taking some capacity on gas pipelines through the Benelux region.

We've created a foundation for future growth, but there's a lot more we need to do. Now I admit to some disappointment over our inability to grow more quickly in Europe, where we've continued to be frustrated by the lack of liberalisation and the barriers to new entrants. We've been lobbing extensively and there's certainly a growing recognition of the need for liberalisation as this chart shows. There are already some signs of positive change. A week ago I was with the European Commission in Brussels when they confirmed that the lack of open access across energy markets is raising the cost of energy in the UK. And whilst they stopped short of naming and shaming, they've indicated they'll shortly be launching anti trust measures against some European energy companies.

The commission also stressed their total commitment to a fundamental restructuring of the European energy market place. I genuinely believe that momentum is going to build behind the changes that we've already started to see.

We know what we want to do in continental Europe. And I'm certain that the efforts we're putting into it today can create significant shareholder value in the future.

To finish I'm very pleased with what the business delivered in 2005 and I'm confident we can meet the challenges of 2006, but it's going to be another tough year. The initiatives I've been driving through over the last 6 months will remain very firmly on my agenda in the first half of this year. And there will be no let up in terms of getting the costs down further, managing the retail price increase, continuing the systems implementation and delivering continued growth. I'm determined to keep the momentum going to ensure a solid business platform for my successor to build on. The whole management team is absolutely committed to ensuring that 2006 is another year of operational progress, financial delivery and creation of shareholder value. Thank you very much.

Questions and Answers

Philip Green Merrill Lynch
Phil I'm just really trying to understand or make sure I understand very clearly what you're saying regards to page 10 which is the debt and interest side and the working capital implication is 500 million. Now I understand what the customer lag would be, quarterly versus monthly perhaps which is half that, but I'm trying to relate that back to your statement on page 2 of the actual release which says that you also believe that there is a potential impact from the actual retail price increase itself and I would have thought price increase would be beneficial unless you're assuming perhaps a greater loss of customers or something. So that's the first question, if you could answer that please and secondly just on the 2 million fixed price customers, how much is that costing you now given the move in wholesale price, if you mark it to market? Thanks.

Phil Bentley
Okay, the first part of that question, obviously the working capital movement, is I think everyone understands, I mean we pay for gas say from BP on a shorter credit period then our customers pay us for the gas so that requires us to have more working capital in the business. On top of that we have margin calls which if we're in the money we get cash in on the margin to keep them topped up to the mark-to-market value then when they deliver effectively that cash goes out so that's the two elements of the 500. The comments about the current market conditions and the recent price increase just simply to say look it's too early to get a view frankly in terms of what the impact is going to be on customer churn, what will competitors do and all we're saying is you know, it probably prudent just to bear that in mind until we see that play out. I mean early indications are reasonably positive, frankly.

Sir Roy Gardner
Do you want to pick up the other element, or let's ask Mark to pick up the question on the 2 million fixed price customers?

Mark
I mean as you probably know what we've done is segmented our portfolio on the 2 million fixed price so we've effectively got we using our portfolio to support that, and then obviously the rest of the portfolio that floats we use for our floating customers, so there is a match there so if you mark to market that against the portfolio we're still quite comfortable with the product and the position we've taken.

Thanks.

Bobby Chada, Morgan Stanley
Just a couple of quick questions, one is to follow up on the working capital and just to be clear should we view this as an intra year move or a change in working capital that

is a negative outflow in cash terms that you expect to see there by the end of the year and will only revert back in future years as commodity prices start to fall and then secondly on costs from memory in September when you talked by the cost reductions I think it was from a 2004 base so £1,050 million and the Opex figure in the back of pack seems to have increased by about £40 million. Is that just a re-statement of costs and where do you expect the numbers to fall to '07 versus '04 now.

Phil Bentley
First of all in the working capital, half of that is just timing differences around '05/'06 which is the margin point so, the £250 million if you like, is permanent as a one off, if wholesale prices don't fall, but obviously we believe infrastructure gets built you'll see the reverse of that effect in '07 and '08 as working capital requirements decline along side the forward curve. Thank you both for spotting it. IFRS changed some small points on Op costs so £1,050 million is absolutely right went to £1,088 million and it's just simply around some of the treatment on some IFRS points. The net we're shooting for by 2007 is just under £900 million, around £870 million, so that's where you get the delta there… we're pretty comfortable overall.

Martin Brough, Dresdner
Could I just ask another point about the fixed price offering, not so much the one that you've done but the one going forward? In terms of what is customers' positions there if a lot of customers do sign up and then wholesale fall off dramatically maybe other suppliers or yourselves are offering ongoing deals below where the current fixed price is, what's the position of those customers if they want to walk away? Do they have compensate you for 2 or 3 years worth? Has Offgem sort of clarified it's comfortable with that? Would you be able to implement that in practice.

Sir Roy Gardner
Good question, Mark are you going to pick it up?

Mark Clare
Yes actually, there's a cancellation charge associated with all the products and that is partly a regulatory thing so there's a real cost if you like putting the position in place, even though we may not physically do that, but we actually have to account for that. There's a cancellation charge for 2009, which I think is about £50 if you take both fuels so it's not that material but nevertheless that's in place.

Martin Brough
But if prices fall off significantly customers could just pay £50?

Mark Clare
They could, obviously its like fixed rate mortgages you can effectively get somebody else to pay it and what I would imagine is, if we see wholesale prices falling quite dramatically, then we will probably be the first in the market with some sort of solution proposition for those customers, probably based around loyalty, I suspect.

Andrew Wright, UBS
I wonder if you could tell us a little bit more about the profit movement in your European business which moved into a small loss and is that related to the acquisitions you made in year. Is that start-up losses, or losses associated with growth

and how do you expect that to change going forward? And also related to the European business you've made some fairly disparaging comments about the approval for the Gas Natural deal with Endesa by the Spanish government. Do you feel more or less comfortable with the prospect of the EON merging with Endesa?

Sir Roy Gardner
Well Phil, in addition to being Finance Director, is also Managing Director of Europe so he'll pick up the first part of your question but in terms of the potential merger of Gas Natural and Endesa we were totally against it, because we are against mergers that which create national champions which effectively forecloses the market before competition is truly introduced and that's a position that the Commission support as well. In fact they would have liked to have ruled on that and now I think they have told the Spanish government to clearly stay off the pitch in terms of ruling on the EON offer for Endesa; they will take a view on it. If it appears that that also will foreclose the market and there is some huge irony here, in that EON who is the national champion in Germany who we all fought against, is riding over the hill to actually avoid the creation of the national champion in Spain. But, we'll wait and see. I suspect the commission will have a lot to say about that approach.

Male Speaker
I mean obviously the stitch up, if you like, with Gas Natural and Iberdrola would have to led to just two collaborating competitors whereas at least with Eon it's still three in the game and so obviously we'd prefer that. The situation with Europe, Oxxio and SPE are trading profitably in 2006 so it's not as if there's a lot of start-up costs there; it's simply out of the £9 million loss there's £14 million of amortisation of fair value charges. What happens there is that if you buy into a business that's got in-the-money contracts already embedded in the business you actually have to amortise those in-the-money-contracts over the period of those contracts. So if you've got some short term in-the-money traded positions that are profitable you actually have to write them off, whereas in the old days they would have just been part of good will so it's an IFRS treatment there but underlying EBITDA is positive.

Peter Atherton, Citigroup
Two questions, firstly just on the Rough outage You have declared Force Majeure on your contracts with the storers. Can you just explain to us why or on what basis you have declared Force Majeure? And tell us whether that is challengable and it is likely to be challenged? Have you had any indication yet from anybody that they might challenge your declaration of Force Majeure? I'll come back to mysecond one.

Sir Roy Gardner
Well, this now gives me an opportunity to introduce Grant Dawson who not only is our general counsel but because of the very high Chinese walls we've had to build between our businesses is actually the Executive responsible for Rough so maybe Grant you would like to pick this one up.

Grant Dawson
We have declared Force Majeure. You'll have probably seen the announcement that we put out on the storage web site. At this stage a number of companies have come back and simply reserved their position and the whole issue of the event itself will get

determined in due course. So it's too early to say, but the event itself we would say falls within the definition of the clause in the storage contract.

Peter
If it's easy to explain why it's within the definition could you?

Grant
Fire, explosion, failure – those are the words in the Force Majeure contract.

Peter
My second question is just on the gas prices over the winter, there's lots of commentators coming up with lots of different explanations of why prices have been as high – some people questioning whether they can really be justified given supply and demand over the winter, some saying no, some saying yes. I would just be very interested perhaps from Jake if we could have a commentary from your angle about how prices moved over the winter and their justification or not?

Sir Roy Gardner
Yes, well certainly, Ofgem have expressed a view, and we support that view but there are other factors as well, but Jake perhaps you would like to pick that up.

Jake Ulrich
Yes, it was an interesting winter as you are well aware, in the fall and going into December. November was a month where Month Ahead prices were priced 30p lower than we actually saw Day Ahead. Coming into January we had the reverse, where the month ahead was in the 93p range and the system average price and the daily ahead were down in the 60's. I think a lot of that is based on behaviour on continental Europe and we saw, early in the year, a reluctance to sell gas into the UK. You will probably see the Jonathon Stern article in today's paper, but there is clearly a security issue on the continent and a lack of commercial drivers to move gas through the interconnector early in the season. I think the early cold really set a lot of people on edge and really caused the forward price to ramp up on speculation that things would be very tight. And we get to January and the weather is not so cold, there's plenty of gas in storage as it turns out and prices come off again. Today and yesterday we're seeing full flow on the interconnector into the UK. Everybody's comfortable now with their winter position. So I think a lot of the dynamics have been around people's worry or anticipation of not having enough security, if the November/December weather had been maintained for the first part of the year. We still think that the curve is over-cooked for that reason. I don't think that people take into account, next year for instance, the impact of Langeled and the BBL line and that will bring the UK supplies up by about 10%, which should be more than enough to cover even a pretty cold winter.

Andrew Mead, Goldman Sachs
I have two questions. One is just on the industrial and wholesaling outlook, your £300 million+ loss you are indicating. Is that also predicated on your view that gas prices come down, or have you actually locked in the gas for that part of the business? My second question was just on the tariff decision. In that you have gone for a reasonably high, certainly compared to so far tariff increases, is that more driven by

being braver on the profitability front or is it more driven by the fact that you see better resilience in the second half of last year?

Phil Bentley
The I&W, the gas that we have to buy is still within the hedge ratios that we have given guidance on before. I said in December for example we were about 80% hedged in 1Q and obviously we have been hedging out subsequent to that as well. So to the extent that there is some gas exposure in our total book I&W has a piece of that. But I think the important thing there is to recognise that in 07 some of these heavily out of the money contracts are starting to expire and even on today's market forward curve we'd expect a major reduction in that number in 07 and probably break even by 08 frankly, because some of the contracts are still in the money and you're getting that lag effect of the price adjusters coming up when the curve is starting to soften.

Roger Carr
I think the bravery point, I think bravery is always a sort of scary word and the complacency of believing that you can manage customers as you did last time in a new world is also a little dangerous, so both of those sort of adjectives I think sit on one side. There was a clear economic model reason for moving as we did - you should just be very clear on that. Mark?

Mark Clare
You're absolutely right Roger, we took quite a lot of pain of course in 2005 and that's clear. There is only so much pain you can take because we have to run a profitable business because of the investments we are having to make to bring new gas to the UK. So it was very clear for us when we looked at the forward curve for this year that the very least we had to do was, of course we needed to reduce costs, we needed to do all the things that we did last year, but we had to pass through the bulk of those wholesale costs. Then the decision was do you do it in one go or do you do it in two goes? When you look at the volatility going forward, we honestly don't know what the second half is going to look like. So we took the view that we had to, not take a bold step, but actually pass through what we could see and of course that is different to what our competitors are doing. They will go for multiple rises this year, we know that. But I think that customers have really wised up to what is going on and we have done a lot of research and we listen, I am sure you have all seen a lot of the press reports. People understand that this affects all companies in the same way and short term switching is becoming a bit of a mugs game. So we are pushing that very very hard, but the reality is, the economics said to us we had to do what we've done. Then we have to work very, very hard to keep all our customers.

Roger Carr
Yes, we are here to make a profit. I think the other thing too, the marketing push that Mark has led particularly is something that the business is getting much more focused on. There has been a lot of thought applied to making certain offers that can be attractive and I think that is very much part of the way the business will work going forward and it's part of Roy's legacy that that attitude of mind will stay in the business. I think equally when you look at the Services business, the reason we split it off was to give more focus on that so that the reason for staying with British Gas through our service and our Service segment was more evident. Chris, I know you

have done a lot to move the business on. It's probably worth you saying a few words on what you've done in the last 6 or 9 months to push on the business performance.

Chris Weston
The Services business as you know has been split off from the residential business. We have been organising ourselves to take advantage of the growth that is obviously there in the market. Traditionally we have focused on purely the British Gas residential energy base. We have taken the decision and the steps to start targeting the whole of the UK market. So it gives us a broader opportunity to go forward to grow the business, both in our core business, which is the gas service and repair business, but also in the new businesses around plumbing and drains and around electrical services where we will continue to cross sell those businesses, those products into the core service and repair business. Particularly pleasing is the growth that we can see in the core service and repair business, primarily through taking greater advantage of the on-demand market, the emergency breakdown market going forward. Having said all that it has to be done in the context of recognising the value that customers see in having the product association with the residential energy business – the stickiness of that product, the multiple products under one brand. We have made some good progress on that and I am confident we will see some good growth going forward.

Edmund Reid, Cazenove
Two questions. The first one is just on British Gas pricing, I wonder if you could give us a feel for post the price rise what the absolute differential will be on say dual fuel between you and your competitors and how that compares historically?

Sir Roy Gardner
Of course this is a timing issue and depends very much on when our competitors come through with their prices which as Mark said they will have multiple price increases through this year as they have done in the past. Mark?

Mark Clare
There are about 50+ propositions out there today if you look at all the energy companies. If you get to a settled position and that's really the only reference point we can take, so let's move to the one before the latest set of price rises, I would say you are talking about £40/£50 difference between the various companies for dual fuel supply. When you consider the size of bills the percentages are probably 4% or that sort of order. When you take the extreme – we have got a product out there which we brand "Click Energy" which is incredibly aggressive in price and is actually up there even today on some of the websites as one of the best prices. So we have got the diversity of products and proposition for customers so that we can cover the price sensitive group as well as those who want to stay with British Gas because they know we are the strongest company whether it's from a Home Services point of view or because of what we are doing investment-wise. So it is not a simple answer but if you clear all that away and you look at the same sort of proposition for each company you are talking about £40/£50 difference between them. Obviously this set of price rises is going to open that gap right up, but then if what we have seen before - and the pattern has been absolutely consistent for the last 4 years - it will all close right back down again because in the end we are all buying, certainly gas, from pretty much the same place, the market. While we have some advantage there, others have advantage in electricity and that seems to balance out. So the real battle I think is about the

propositions that we deliver, the brand, the service and all of that and that's where the investments we have made in the systems which are going very very well really give us the edge going forward.

Sir Roy Gardner
In fact the BBC has just coined a new phrase for us this week, "Save energy - switching won't save you much".

Edmund Reid
My second question was associated with that. It is very hard to get a number but do you think that your cost base is the same as your competitors? Do you think you are on an equal footing at the moment?

Sir Roy Gardner
The intention is that we will be the lowest cost supplier in this industry and that's where we are going to get to. Mark you may want to elaborate.

Mark Clare
Another difficult one because have we got transparency of Eon's cost base? No we haven't. There have been some comparisons done by third parties and that would say that we are unfortunately at the wrong end of the pack if we look at 2005 - 2004 certainly - but we are not the highest. The difference between us is a few pounds so in terms of the overall energy bill today it is very, very small. The target we have set ourselves in 07 and going on to 09 puts a substantial gap from where we were in 2004 and also between us and competitors and there is some real advantage to be had. We have to assume they are going to follow us but again the platforms that we are putting in place - outsourcing and offshoring the back office - the modern systems that we are putting in give us so much more flexibility to run the businesses we want rather than always being dragged back because of the legacy systems that we have had to rely on, so we are going for a very aggressive cost to serve, focusing on 2007 as the year of delivery. Then, further pushing that into 2009 - and that isn't about shaving another 5% off the finance budget - it's actually about fundamentally looking at the way we do business. So we have a review going on at every process that we operate, and because our processes are big we are talking about 100s of millions of transactions, so really focusing on those processes and finding a better way, a different way to deliver those. The offshoring is part of that and the benefit that we are getting already from working with our partners over there, who are very process orientated, is starting to come through so I think there is real benefit we can get by changing the way we operate not simply shaving some more money off our current cost base.

Phil Bentley
To add to that, the Datamonitor survey that Mark referred to before shows an average cost to serve of about £20 – we should be able to take about 30% off that by 2009. So 2007, as I said before, has a big step-down but we are not stopping there. The real longer term target is 2009 – 30% off the cost to serve.

Iain Turner, Deutsche Bank
Can you talk through what you think the risks are that the various bits of pipeline and LNG infrastructure may end up being late and how you manage that risk?

Sir Roy Gardner
We don't think they are going to be late. Jake do you want to pick that up?

Jake Ulrich
I guess I will separate the two because I haven't been down to South Hook or Wales lately to see how it is. I don't think that's the important issue right now. It's next winter and it's the BBL line and the Langeled line. And in our communication with both parties, with Gasunie and with Norsk Hydro, and with the leading construction on the other side, they are on schedule. When the summer arrives we will have a pretty good feel whether we are talking about September 1, October 1, or December 1, where in the winter it arrives. I don't think it's whether it comes in or not next winter, it's a question of whether before the winter or during it. I am relatively optimistic that the Langeled line will be ahead of schedule and I think BBL will be on schedule.

Richard Alderman, Merrill Lynch
Question to the Chairman if I may. Back in September you were kind enough to give us a direct answer to the whole issue of this bid speculation. I guess clearly as you pointed out there has been significant volatility in your share price recently. I wonder if you could give us an update on that process, on the same question you were asked in September. Since then has anybody approached you and if so are you still talking to them? Any company?

Roger Carr
Since the last meeting we have actually had a further tightening in regulations that would put us in jail if we answered anything more than "no comment". I think that's the comment you should take from the meeting, but to read nothing into that at all. We are running this business as an independent, to deliver value to shareholders as an independent – if somebody comes and pays a material premium for this business on top of a fair value that is good for shareholders then the Board are very clear about its responsibilities. You can be very sure of that.

Jamie Tunnicliffe, ABN Amro
You mentioned earlier that you felt that the forward curve for gas was over cooked. Just interested whether that has led you to sort of do anything different in terms of your policies and hedging ratios etc. that you have guided on in the past. Or are you basically carrying on against the previous guidance you have given us?

Phil Bentley
We are within guidance. Remember we have those step down bands and we are within guidance within that. It is fair to say we are more likely to be at the bottom of that than at the top given our view of the forward curve and the infrastructure impact on the prices, bringing that price down.

Roger Carr
That brings us back to schedule. Thank you very much for coming.