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Presenters

- Phil Bentley

Operator: Thank you for standing by and welcome to the Half Year Trading Update conference call. At this time all participants are in a listen only mode. There will be a presentation followed by a question and answer session, at which time if you wish to ask a question you will need to press *1 on your telephone. I must advise you that this conference is being recorded today, Friday 24th June 2005. I'd now like to hand the conference over to your speaker, Phil Bentley. Please go ahead, Mr Bentley.

Phil Bentley: Thank you, and good morning, everyone. Thank you for dialling into the Centrica Half Year Trading Update. It's actually done through a Onetel line in India, and I'm sitting here in a very sunny Brussels office. I guess it gives a sense of the growth of Centrica.

I thought I'd just start with picking off a few highlights from the trading update. Obviously the most important point is that we are confirming guidance for 2005 that we gave earlier in our AGM statement. If you recall, I think market consensus on a UK GAAP basis is around 21 pence per share and our IFRS basis, pre-IAS 39 adjustments around 18 pence a share. But obviously with the higher wholesale gas prices, we are expecting now to be earning more from our upstream division and proportionately less from downstream.

If we take the first five months of trading this year, trading has actually been pretty good overall and commodity prices, although they are at historic highs, are lower than we had forecast in our plans and certainly lower than the forward market had predicted. Market gas prices, about-turned at 32 pence to the quarter, have averaged about 30p for the second quarter to-date, and the day ahead now is around 31-32.

But obviously it's the second half where I think everyone's focus is on and 2005 demand weighted, so this weights our own demand for the winter period. Wholesale gas price is now around 41 pence a therm and that's some 51% higher than 2004, when we saw prices around 27p. And just to give you a context there, our own British Gas WACOG last year, [full year], was 25.31, and that's obviously gone up since the AGM statement, when we were up only 44%, and at the time of the results announcement in February we were up only 29%.

And a similar picture in 2005 for power as well, where 2005 total is at £35 per MW hour, 43% than the prior year and again up from when we did our AGM and our prelim statements. And if you look at the winter 05/06 period, then gas there is up 105% compared with the same period in the equivalent 12 months before; power is up 89%. So winter periods, I'm sure we'll have some questions about.

Again to the end of May, our British Gas weights average costs of gas came out at 29.5p. You'll see that's lower than the market. Our average cost of electricity £33.6 per MW hour, slightly up on the market, largely because the impact of our gas-fired power generation. And again we're flagging that these WACOGS's and WACOE's will rise in the second half of the year. And then inevitably this will put pressure on downstream margins in the second half, and I think we've flagged the need to further increase retail energy tariff as have a number of our competitors most recently.

So as a consequence, British Gas expects to make significantly more profit in the first half of the year than the second half, although this first half will be lower than the same period last year, obviously impacted by overall lower customer numbers.

And on customer numbers, year to date now we've lost some 445,000 energy accounts, mainly gas – over 80% gas – but since the AGM we've been running around 10,000 losses a week compared, if you recall, to around 22,000 at the start of the year up till the AGM. So churn is coming down and actually that 10,000 a week is running now around the same level of losses we saw last year before raising prices.

We're pleased with our sales and marketing initiatives. The free weekend and evening calls are going well; the fixed price, the electricity-only tracker product as we call it, has raised the levels of our energy contracts sold gross to around 55,000 a week. But also gross losses still are at a higher level than the same period last year. Churn is higher – much higher I guess than we would have hoped – and that's having an impact on our total customer number base. I mean it's fair to point out that in electricity we have now been seeing several weeks of net gains overall. So we are quite pleased with the way that progress is going.

British Gas Home Services has continued to grow well, a trend that we've seen over a number half years now, with our cost efficiencies driving a pretty good half year operating profit, which is ahead of our budget and ahead of market forecast at the moment. We're getting good growth in our central heating care, our core central heating care. Good growth in our installations, and of course the cross selling in the plumbings and drains, kitchen appliances, is also going well. And remember, because of the higher pension charge for our engineers in IAS19, there is a higher charge coming through, but we are seeing greater efficiencies in our overall cost base, and we've now rolled out our new engineer deployment system to just under 2,000 engineers and had very good feedback from the engineers in the field.

Upstream Centrica energy production levels have been in line with the guidance we gave previously, where as you recall we said production down around between 15% and 20%, but obviously as prices have gone up more than that, we should expect to see upstream profits in the first half and the full year to be significantly higher than 2004.

Just turning to storage, the next few lines: we consider storage to be something of a dirty hedge again against the higher gas prices and we've had a very strong first half indeed, both due to the higher SBU prices and much increased reliability – close to 100% reliability and availability. And as you know, when we inherited that asset there was a significant maintenance backlog that we were working through. And we're very pleased with the technical performance of availability.

SBU prices have continued to rise. We've now sold out almost 75% of our available 06/07 storage year, and the prices quoted on the screen today are about 75 pence per SBU. And just to put that in context, in 03/04 year the SBU price was 17 pence; and every 10p on the SBU price, over 455 million units, is about £45 million to the bottom line. So a very good overall performance we expect in storage.

British Gas business: we've maintained our position in terms of customer numbers. We haven't seen the losses that we've seen in the residential market. It is a tough wholesale market, but we have been successful passing through the cost increases to our contracted customers, and churn levels there are actually below 2004 levels, single digit churn levels. And I think that sort of implies that competitors: (a) are not fully hedged on their generation portfolio for business customers; and secondly are acting in a fairly rational way in pricing through to commercial customers.

In North America we've continued to make good progress there. We are growing our customer base overall, and we're quite pleased with the progress we're making in Texas. We should have organically some 250,000 customers in Texas. All were organically now by the half year, and that's outpacing any losses in the incumbent region. You're seeing we put prices up in our CPL area, and we've not seen a major impact in terms of increases in customer losses.

Business markets: we're making good progress there. We've just signed a UPS parcel service in Texas, and we are adding some pretty big accounts now. Overall, first half versus last year, if you recall we had the exceptional charge 2004 due to the Texas true-up. So '05 versus '04 will look particularly good.

I mentioned I was in Brussels at the moment. We are making good progress on our European strategy, and you'll have seen this morning we had announced completion – not completion, but signing, I should say – of the acquisition of SPE, of a controlling stake of SPE, in partnership with Gaz de France. SPE is the second largest power generator in Belgium, and as part of the transaction we are selling into the new venture, if you like, our existing Luminus JV. Overall, the value of the SPE deal is some just under €1 billion, and we'll have just over 25% market share.

On top of that, you'll have seen we announced the acquisition of a Dutch supplier, Oxxio, in the last month or so. In fact, together now we'll have some 2 million customers in what we consider to be very key markets to development in European competition.

Onetel, as I mentioned, successful transfer activities to India, and we are seeing strong growth in our fixed line customer base. And the British Gas cross-sell, using the door-to-door sales channels and inbound calls in the British Gas call centres is really driving some good growth. as you know, acquisition costs don't immediately pay back in terms of additional margin, and so the first half, if we're growing – as we are growing – quickly, profitability will be lower that what we saw in the second half of last year. And obviously we're pleased with the outcome announcements yesterday of the Ofcom strategic review, where the access services division new brand will be separated from BT retail. Wholesale line rental will be located in the ASD, and we should expect to see much greater competition in both WLR and broadband.

We are going into our closed period, and our results on full IFRS basis will be announced on the 15th September. On the point of IFRS, I mean I think we went through fairly comprehensively the impacts at the earlier seminar this year. I just wanted to flag the overall impact of IAS 39 on the income statement, relating to the change in fair value of our sales and procurement contracts. And to the end of April that was showing a credit of 194 million pre-tax, and obviously, as prices continued to go up in May and June, we'd expect to see that number come in higher again. Now of that, some 100 million relates to the unwinding of the opening balance sheet adjustments, in the main in the I&C contracts, and some 94 million relates to the changes in the forward mark-to-market position.

We're also announcing – have announced this morning – that we've made good progress in our first £500 million buyback programme. To date, we've repurchased for cancellation some 185 million shares at a total of 437, and given the rate of progress we're making, but also our view of where value is, particularly in upstream gas investment opportunities, the Board has decided to undertake a further £500 million buyback programme, which will commence on completion of the first tranche, as it were.

We're also announcing today that we will forward, before the closed period commence, an irrevocable, non-discretionary programme where we've given pre-instructions to buy to our broker, which will run till the end of the closed period on September 14th.

So I think, to sum up, I think we've had a pretty good start to the year, and 1H results will be strong. We are flagging we don't want the market to sort of run too far ahead, given the pressures for second half of '05 and also '06; and I think it's fair to say it's going to be tough going if prices don't soften. We still think the curve will soften, perhaps we'll get on to the recent Transco forecast in the questions, but I think it's fair to say it's going to be tight. It's going to be tight over winter. But we are prepared, as we've signalled before, to make the tough decisions regarding pricing to maintain margin.

But obviously we can't just think of Centrica as just a short on the gas market. We're a lot more than that. We've got quality assets. I think I flagged up how profitable Rough will be this year. And across the total Centrica portfolio we are growing customer numbers; despite the fact that British gas is down we see a good environment for reform in telco and Europe, and we are delivering total portfolio growth in customer numbers. We're driving operating efficiencies. We're very comfortable with the British Gas transformation target benefits that we've set this year, and we are investing patiently, and I think there's good evidence of that. And we're generating significant cash.

So that's really the story for Centrica. We believe we are undervalued on any sort of PE/EBITDA multiple, and that's why we're continuing the buyback programme – as a source of value creation. So on that point, if I may hand over now to questions and answers – if you could just give me a sense of who it is, hopefully I'll be able to answer the questions.

Operator: Thank you. We will now begin the question and answer session. If you wish to ask a question please press *1 on your telephone and wait for your name to be announced. If you wish to cancel your request please press the # key. Your first question comes from Andrew Wright of UBS. Please ask your question.

Andrew Wright: Good morning. Andrew Wright here. Can you hear me?

Phil Bentley: Yes, morning, Andrew.

Andrew Wright: Hi there. Right, I just wanted to ask you a question about your current position on contract coverage or fixed price coverage for both the fourth quarter of 2005 and the first quarter of 2006, you know obviously including the hedge from Morecambe Bay. What's your position on that now?

Phil Bentley: I mean, as we said before, these are fairly commercially sensitive positions. Clearly we haven't flagged exactly what our percentage is. It's reduced since we last spoke, but that doesn't mean to say that at some point we might increase it if we felt the market was overboard and we choose to unwind a few of our positions. So I'm not going to give the overall picture, but I think, yes, we do have some exposure. It's probably lower than a lot of the market would, is probably forecasting at the moment and we're comfortable with that exposure as we go into the winter period.

And I think if you look at the Transco view, the number of scenarios there, but just sort of unpicking that a little bit more, they are seeing greater demand growth, on the demand side to start with, than we believe and just take the weather for example. They take a 76-year weather data with equal weighting; it doesn't reflect increase, if you like, in global warming. But in the last 15 years 13 winters have been warmer than that 76-year average, and 50% of the warmest winters ever since 1928 have been in the last 10 years, 7 out of 10.

So I think they are predicting probably a fairly sharp, cold winter, number one. I think on the supply side, we believe we'll see more capacity coming in from Grain. We see, I think, probably some more capacity coming in from the interconnector. So we are sitting down with Transco at the moment and sort of comparing our view of the world with theirs. Obviously I think its right that they take a fairly cautious and conservative view of that supply and demand picture.

Andrew Wright: Right, thank you very much.

Operator: Your next question comes from Bobby Chada of Morgan Stanley. Please ask your question.

Bobby Chada: Morning, Phil. I just had two questions, please. On the margin side for British Gas residential energy, the statement seems to imply that that would be down year on year, but then just in your closing remarks, you said that you would take the tough decisions to maintain margins. Are you flagging that it'll be down year on year, or that you think it could be flat year on year? And then on the investment side, you said that the Board had sort of taken the view that upstream investments were much harder to find, or at the wrong prices. Does that mean that you've re-evaluated the four year investment programme?

Phil Bentley: Ok, thanks for that, Bobby. Again I mean it's sort of commercial sensitivities around our precise plans. Do we want to do one large price rise, or one in '05 and one in '06? I think that's an active debate that's going on at the moment. I think, the overall efforts, if you like, to retain margin – commitment to retain margin – are there, but I think in terms of the tactical execution of that, we're not going to show our hand too soon.

I think if you sort of do the maths backwards, from working out where the overall upstream profitability is going to be, based on the forward market, and the fact that we're in line with consensus and are flagging that we'll make proportionately more upstream, I think you can infer that therefore we'll make proportionally less downstream. But that's not inconsistent with our view that we will pass price rises through; it's a question of timing and tactics around the execution of that. So that's obviously something we're not going to flag to the market and our competitors.

In terms of the upstream investments, we set a 5-year programme, as you know there is still, certainly not just the view that we hold, but a view generally in the market that as more gas becomes available into the UK – and I think Morgan Stanley are one of those supporters of that, if you like 'wall of gas' view – there will be some opportunities. I think what we're flagging is not a change in the investment plans, but simply saying that some of these assets which are being optioned in well understood geological bases, such as the North Sea, look pretty pricey to us. Does that mean we can't get a bilateral deal done further afield? No it doesn't and that's something that we are working very hard on, to see if we can deliver. So I don't think we're in any way signalling an overall stepping away from our intent there; we're just signally simply that I know some of these option deals are, in our view, represent poor value.

Bobby Chada: Ok, thanks very much.

Operator: Your next question comes from Robert Canepa-Anson of Newton. Please ask your question.

Robert Canepa-Anson: Hello. I just wanted to clarify on the comparisons with last year's profit. Is that pre or post the £98 million exceptional charge going through that, I think, that half? Thanks.

Phil Bentley: Could you repeat that question? I didn't catch that.

Robert Canepa-Anson: I was just looking at last year's results for the first half. There's a £98 million exceptional charge going through in that period. I was just wondering the comparisons you're making to last year's profit, is that pre or post that exceptional charge?

Phil Bentley: Yes, all our comparisons are pre-exceptionals. We've also got the AA profits in exceptionals as well, that would dwarf that, so no we would look at it on a clean and like-for-like basis.

Robert Canepa-Anson: Right, thank you.

Operator: Your next question comes from Iain Turner of Deutsche Bank, please ask your question.

Iain Turner: Morning, Phil. Can I just ask for a bit more flavour on the SPE deal, what your plans are in terms of how you take that business forward and what you're trying to achieve with it in Belgium?

Phil Bentley: Yes, as you know, Iain, we had a JV with Luminus that gave us around 800,000 customer accounts and that was in the Flemish part of the markets. If you know anything about Belgium you'll know that there is quite a local flavour in local sort of regulatory between the Walloon area and the Flemish, and the Flemish market has opened. We've been growing our customer base; we've been cross selling from electricity into gas, and; we've been starting to introduce innovation around fixed price contracts, and also we're trialling a home service offer at the moment. So we've been, if you like, active since the very end of 2001, in a competitive market, but obviously we had no generation position, and the big generators in Belgium are Electrabel and SPE.

Now SPE did not have… It was operating mainly out of Walloonia, where the market hasn't opened for competition. And so putting our experience of working in downstream markets with the need to get a better vertically integrated hedge, but also recognising that the Walloon market is opening for competition in 2007, if we can steal a march, if you like, before that as owning the total entity, we feel that we can certainly attack Electrabel, who have some 80% market share today. So this leapfrogs us to vertically integrated, able to cross sell into dual fuel, and ready to take on Electrabel. So we're pretty excited about what this opportunity could bring.

I think with Holland, again we see good progress in deregulation there, we believe that a number of other transaction may well come to market in the next 18 months or so. By buying a business in Holland: (a) we add credibility to any bid; (b) we get to understand better how the market works and where we can get real value and synergy from any further acquisitions. So I think the slowly but surely, it's a bit like Ofcom and BT, the Commission slowly but surely is getting after these markets that are somewhat protected to date. You'll have seen in Germany recently changes in law there that start to open up access to distribution and transmission and separation from supply and generation. So slowly but surely these markets are opening, and obviously Belgium and Holland something of the transit lounges for gas into the UK, are important markets and we need to be here.

Iain Turner: Thanks very much.

Operator: Your next question comes from Dominic Ash of CSFB. Please ask your question.

Dominic Nash: Hi there. It's Dominic Nash actually. Two questions, if I may, firstly on the CRM system. That seems to be very little mentioned of the CRM system, could you please just remind me of what the current status, as well as your expected timescale and benefit? And secondly, probably following on from a question, I think, that Bobby might have brought up earlier. Is it possible to quantify the level of price rise required in order to achieve the consensus guidance please?

Phil Bentley: Well, I can deal with the second one first, because we're not going to send signals to the market about what price rises we are contemplating, but even in the Daily Mirror on 22nd June they were talking about 15% to 20% price rises that were in the offing. So I think if you're looking for where expectations are, that's the sort of ballpark. We're talking about price rises that we've not, no ones seen or done before. We thought 12% was pretty racy last year, and it's fair to say it's likely to be more than that.

I think that the other point to emphasise though, Dominic, is if you look at price rises for the industry since 2000, in gas we've raised prices 27.8% over that time; everybody else has done around 30%. The average is 33%. So what that signals is: we've done 28%, the average 33%; competitors in gas are acting in a fairly rational way. They may delay the price rise equivalency for a short time, but they are acting in a rational way. I mean power over the same period, we've done 10.4 and the average is 14, which is actually 35% more.

I think we are acting generally in a rational way. I think our message to consumers this time around is going to be, look you switched last time and then people put there prices up to similar levels to British Gas, there really isn't much point switching, because this is an international commodity and I think you'll see a little bit more aggressive, or comparable, advertising to get that message over to consumers, because consumers still think that British Gas has raised its prices and nobody else has, and the facts just don't support that.

In terms of the CRM, we haven't said anything because we've just sort of plodding on through and plodding on sounds sort of somewhat laborious but we're into the testing, this is the most important phase of the billing programme, and we are testing this to, not to death, but we are testing it rigorously. We've done all the functional testing, we've completed product testing, we're now into user acceptance testing and if you think about, particularly in SAP system where it's very good if everything sort of fits the model and sails down the tube as it were, but we always have exceptions. You'll have exceptions around meter reads, around data and we've got to make sure that our system is robust to the unusual rather than the routine. The routine will work, it's the unusual that we want to fully test as well.

And then our pilot is on track for, it's just going to be – the beginning of the third quarter, so July August time is when we'll go into the pilot. We'll start with 50,000 customers that should give us a sense and a flavour of how it works on a day to day basis, and then we'll start to roll that out over time. In terms of guidance that we've given before in terms of delivery of benefits and when the programme completes we're not saying anything different now, and that's why' frankly' we didn't comment this time.

Dominic Nash: Thank you.

Operator: Your next question comes from Andrew Mead of Goldman Sachs. Please ask your question.

Andrew Mead: Hello, hi. Is there just sort of any comments on the tax outlook for this year, given your comments on the consensus and also your comments on the upstream.

Phil Bentley: On the what, Andrew?

Andrew Mead: Pardon?

Phil Bentley: On the – comments on the what?

Andrew Mead: Tax. On the rate for the year, given your comments on, as I said, the EPS issue but also of the upstream business. And secondly, just on the industrial and wholesale business: have you found any way to sort of protect yourself against the higher gas price impact, or are you still basically looking to take that on the chin?

Phil Bentley: We are taking it on the chin at the moment. we are, we have had a couple of sort of discussions to see if we could get out, but frankly, it looks pretty penal to us at these levels. And I know we've been saying that for a while and the levels have gone up, but you know, there isn't a lot of this forward market hedging that we can put in place for what are not particularly well correlated sales prices with input costs.

So there's no real change in that. I mean, the only change – and I think Bobby has picked this up before – is that obviously you've now got it on the balance sheet, so when it delivers it unwinds as a credit, which is somewhat perverse, but clearly from a cash point of view there's a reconciling difference between reported post-IAS 39 EBIT and EBITDA, if you like.

The tax – I mean, yes, the tax rate has been sort of creeping up. No, we're not going off the guidance that we gave before; I think we sort of said 32-33 ETR. Yes, we do have still a number of tax losses that we are working through. We do have still some tax structures that are permitted under the rules, as it were. It's getting tougher, it has to be said. But you know, that's about where we are. Obviously, as you're signalling, the upstream profitability is taxed that little bit higher, although that doesn't include Rough.

Andrew Mead: Thank you.

Operator: Once again, if you wish to ask a question please press *1 on your telephone and wait for your name to be announced. Your next question comes from Bobby Chada of Morgan Stanley. Please ask your question.

Bobby Chada: Hi. I just wondered if you could give some updates on where you think your cost to serve per account is moving to at the moment, given that you've done a large part of the initial back-office transformation and you took out the sort of middle office last year as well.

Phil Bentley: Well, I mean the overall energy operating cost base should fall by about 100 million this year. If I look at pure play energy cost base is just over £1 billion, so it's coming down by about 10% there. I wouldn't take away, Bobby, that we've done a large part. We've done a lot; but I wouldn't take away that we can't do more. I think the learning we have in Onetel, for example, in terms of the offshoring activity that's done there, certainly would indicate to us there are still further opportunities for us.

So you know, the first things we've done is get the efficiencies around processes, but the next, if you like, decision is: having got to that point, does an outsource in certain areas make sense. And certainly, our view is that you can't outsource when your processes don't work, but you're in a much better negotiating position to do so once you've got that. So you know, I wouldn't rule out a second round, if you like, of further cost efficiencies to go.

I mean, we always hesitate to give reductions in costs to serve, because everyone has it sort of differently, but I think overall, in terms of our cost to serve reduction, I think it's fair to say we're probably targeting, on a per customer basis, something like 30% to 40% reduction at least.

Bobby Chada: That's the target over the long-term, is it?

Phil Bentley: Yes, yes. As opposed to the – we've say probably done 10% at the moment.

Bobby Chada: Ok. Thanks very much.

Operator: There are no further questions at this time. Please continue. There are no further questions at this time. Please go ahead.

Phil Bentley: I think I was accused of cutting it short last time, so I do want to make sure I answer all the questions, but if there aren't any, obviously Kath and Kieran are on the phones today back in the office, and will be happy to take any follow-up questions.

Operator: Once again, if anybody wishes to ask a question they'll need to press *1 on their telephone and wait for their name to be announced. There are no questions at this time, Mr Bentley.

Phil Bentley: Ok, thanks guys. See you later. Cheers.

Operator: That does conclude our conference for today. Thank you for participating. You may all disconnect.