Centrica
Interim Results Presentation
29 July 2004

Opening Remarks

Roger Carr, Chairman

Good morning. I would like to welcome you to the presentation of Centrica's 2004 interim results. As usual, Sir Roy Gardner and Phil Bentley will present the results and afterwards there will be an opportunity for questions. Today, we also have some of the senior management team here to answer questions alongside Sir Roy and Phil which I think will but helpful.

But first, I would like to preface the presentation with a few comments.

Four weeks ago, we announced the sale of the AA, the return of cash to shareholders, the increase in dividend, and the evolution of the group's strategy. At the presentation, I outlined five key points that the Board believes are critical to Centrica's ongoing business success. These key points are founded on the management competence and financial rigour of the past, strengthened now by the additional investment in cost-effective energy supply for the future, and driven by our commitment to satisfying customers and rewarding our shareholders as our twin key performance goals.

We have strengthened our Board since that time with the appointment of Mary Francis as a non-executive director. As Director General of the ABI and as a director of the Bank of England with deep experience of government, Mary brings with her impeccable credentials in corporate governance, financial discipline, and regulatory understanding. Her insights are going to be invaluable to the successful development of the business in the years ahead.

We will continue to review our Board structure to ensure we are equipped with the right mix of skills and experience at the highest level, which is appropriate to an international energy provider.

The first half of 2004 has been challenging for the energy business, and our results today say much for the skill and professionalism of Sir Roy Gardner and his team. His and Phil's presentations will take you through the details of the results and their context, but I want to draw out two key themes. One is the ongoing commitment to rigorous cost management and control across the business, and the second is the challenge presented by the increases in commodity prices, which are at levels that we have not seen for many years.

As I say in my statement, at these levels, and depending on the impact of commodity prices in the second half, it is probable that we will see increased consumer prices across the industry. Sir Roy and his team are monitoring the situation carefully and will act decisively when appropriate to ensure our competitive position is in line with our commitment to deliver profitable growth.

The Board is clear that it is only by addressing these issues with vigour and determination that we can economically satisfy customer demand, secure long-term energy supply, and fairly reward our shareholders in the future.

Chief Executive's Review

Sir Roy Gardner, Chief Executive

I said in February that 2003 had been a challenging year. Well, the first half of 2004 has been every bit as challenging. Against that background, I am very pleased with the numbers that we have delivered.

1. Results in brief

Turnover, excluding Accord, was up 3% year on year. Operating profit and earnings before exceptions and goodwill were up 10% and 9% respectively. However, after exceptions and goodwill, earnings were slightly down as a result of exceptional charges taken in the first half.

On the basis of these results, the board has declared an interim dividend of 2.5 pence per share and this is a very significant 47% increase on our 2003 interim dividend. It reflects the compounding effect of higher earnings and a material step towards our committed 40% payout ratio this year.

Phil will take you through the numbers in detail shortly, but I want to start with a short review of the key factors that have influenced Centrica's development so far this year.

2. Development of Centrica in 2004

Our agreed sale of the AA not only demonstrates our ability to create and then realise value from acquisitions, but it also marks a further step in our strategic evolution. We are focused entirely on the creation of value through energy and related home services.

As we outlined to you a month ago, we have earmarked a substantial amount of additional investment to grow our asset portfolio in order to underpin our downstream businesses by securing competitively priced energy. In the year to date, we have added a number of new assets to the portfolio, both in the UK and North America.

We have continued our drive towards operational efficiency and competitive cost-to-serve. In British Gas, we have accelerated some of the process re-engineering that forms a key part of the transformation programme.

And, of course, we have committed to both a significant return of cash to shareholders over the next 12 months, as well as a substantially enhanced ongoing dividend policy.

I want to turn now to some specifics from the first half of the year, picking out just some of the key points from across the group.

3. British Gas

3.1 Transformation Programme

Turning first to our major UK downstream business, British Gas. This really is at the core of our business and we are pleased with its progress and financial performance in the first half.

With over 200 million customer contacts each year, British Gas has a huge amount of data about its customers, and also a considerable opportunity to manage our customer relationships in a way that truly differentiates us from our competitors.

We are investing in our systems, processes, and people to ensure that we can exploit these unique assets to create sustainable competitive advantage at the same time as reducing our cost to serve. In February, we showed you a revised timeline for the programme and said that we had decided to extend the testing period for the cross-selling engine. Last month, we were able to start full rollout of this part of the system. It is now being used by nearly 1,000 people and will be fully rolled out by the end of this year.

We have implemented a maintenance release which joins together the Siebel and SAP software, and this really does gives us increased confidence for the next phase of the implementation. The billing system is now built and we are gearing up to start testing it. The first new-format bills will start hitting doormats from May next year. We are confident that the benefits from the programme will be towards the top end of the range that we have shown you previously.

3.2 Home Services

Today, Home Services is really what makes British Gas different from the competition. We have almost 8,000 branded engineers, who give a public face to our brand that our competitors do not have. This business goes from strength to strength. Product holdings, including telecoms, now stand at over £7.5 million, and turnover was up 11% year on year. The scale of this business gives us operational leverage, which has enabled us to turn that increase in turnover into a 48% increase in operating profit.

This is a real source of growth potential and we are investing to ensure we can realise that potential cost-effectively. We have continued to recruit apprentices to our engineering academies and we have begun investment in the engineer deployment infrastructure. This programme will enable more efficient deployment of the 10,000 engineers that we will have by 2006, giving both cost efficiencies and increased customer satisfaction. The infrastructure is now being tested in the live environment with over 200 engineers and is expected to be fully rolled-out by the end of 2005.

The second half of the year will see heavier investment in both the deployment system and also the cyclical replacement of the engineers' laptop computers, which are now an essential part of their equipment.

In telecoms, we have made good progress despite competitive pressures on pricing and churn, as well as the continued lack of a full wholesale line rental solution. We have continued to grow both customer numbers and revenue per user, and we have also negotiated better rates with our carriers. As a result, operating losses for British Gas Communications have been halved compared to the same period last year.

Also in telecoms, we have seen good progress in One.Tel, which delivered a first-half operating profit of £6 million.

When the investment in transformation and Home Services is complete, these factors will be very key points of differentiation and will drive loyalty, giving us a benefit in reduced churn.

3.3 Net Customer Movements

When we talked to you in February, we had only lost 9,000 customers in the year to date, despite our price increase in January, and this was much lower than we had expected. What actually happened was that there was a delayed impact and, as we flagged in our AGM statement, the end of the first quarter saw an increase in churn. In the first half, we lost net 294,000 energy accounts, but churn is now falling back to a more normalised level.

Although we have been losing customers, we have also continued to sell new contracts and, as a result, we have seen a small amount of growth in our electricity customer base.

3.4 Growing value

There are a number of factors that are particularly important to us in growing value for British Gas.

Since we made our forecast last year of an 8% margin in British Gas in 2005, our target has clearly been challenged by gas costs, which have increased by almost 50%. Whilst we remain committed to our target, we will seek to balance the impact on churn with the speed and scale of tariff increases.

The transformation programme is another enabler of value growth and will deliver its contribution towards achievement of the margin target.

Longer term, the balance between market share and premium positioning is high on our management agenda. We have made very good progress in improving the way that we analyse and understand our customer data, and that is the backbone for us to develop new propositions and marketing activity targeted on customer value.

Our priority is to grow market share in our high-value segments through cross-selling and up-selling, and over the last 12 months, despite an overall drop in energy customers, we have either grown or held the size of our higher value segments.

4. North America

Looking outside the UK to our business in North America, in April we completed our acquisition of the ATCO customers in Alberta. This was at a lower consideration than we had originally agreed, ensuring that we preserved value in the light of changes to the legislative and regulatory environment.

To underpin our downstream business, we have invested in upstream assets. We acquired our first power station in Texas and additional gas reserves in Alberta.

Outside of these acquisitions, it has been a challenging period for our North American business. The Ontario market is closed for growth, and in Texas competition has become more fierce. Phil will explain the main drivers of the financial performance in his presentation, but I am confident that our strategy is sound: organic growth in our existing

markets, cross-selling energy and services, growing scale in business markets, and underpinning the downstream business with upstream assets.

In Ontario, we are continuing to lobby hard and we are hopeful that next year we will see some movement towards a more open market. In Texas, with a strengthened management team, the second half of the year will see a much stronger response to the increased level of competition. Our business markets activity is showing encouraging signs, with some high-profile, multi-site customers already signed up.

There is a lot of work for the North American team to do in the second half, but they are focused strongly on addressing the challenges that we experienced in the first half, and we currently forecast that our full-year results will be broadly in line with expectations.

5. Upstream activity

5.1 UK asset portfolio

Turning now to our upstream activity, which is critical to ensuring our downstream businesses are supplied with competitive gas and power. This year so far, we have added to the asset portfolio: we have acquired new gas reserves in the UK side of the Statfjord oil and gas field, we have taken an option to purchase a company which owns one of only three consented sites in the UK for a new-build CCGT station, and we have acquired Killingholme power station.

I am also pleased that we have started to make progress on developing our renewable capacity and we have now awarded the construction contract for the wind-farm at Barrow. We have gone out to tender for the contract to develop the Round 1 Lynn and Inner Dowsing sites in the Greater Wash area. We expect our first green power to be generated from these sites in late 2005 or early 2006. In addition to equity investment, we have also entered into a flexible five-year gas supply contract with Shell, which starts delivery in October.

5.2 Upstream investment

A month ago, we told you about our enhanced investment plans. Building on that, I want to try to give you some feel for where that investment will go.

We have previously given guidance on an average annual 10% drop in production from Morecambe. In 2001, we installed additional compression facilities, which give us some flexibility to turn production up or down to enable us to optimise our gas portfolio. This year, we have chosen to run Morecambe at around the same level as 2002 and 2003. You will see from our statement that first-half production was actually down year on year. That is because we have deferred some of this year's production to the second half in anticipation of higher gas prices. Although we have held up production for the last two years, we expect to see a faster drop-off in 2005 in line with the profile that we have shown you previously.

We cannot replace Morecambe on a comparable profit basis but we are continuing to look for opportunities to replace it volumetrically by investing in other gas reserves.

We are looking to increase our equity gas cover in the UK to around 35% to 45%. We will look for further opportunities in the UKCS, but we have already made clear our intention to

look further afield as well and it is inevitable that future investments will be needed outside the UKCS.

The new sources of gas, including liquefied natural gas (LNG), are remote from the areas of demand and, realistically, we know it may be necessary for us to take an equity stake in some infrastructure projects, both to make sure that they happen and also to ensure that we get unrestricted and fair access to the infrastructure and, therefore, to the reserves.

We are looking to increase our level of peak electricity in the UK to around 65% to 75% and we are interested in acquiring more power stations, as well as pursuing opportunities for tolling agreements such as the one we have at Spalding.

In North America, we are looking for further power stations and gas reserves and, as we increase our downstream presence in continental Europe, we will look to cover a proportion of that demand from our own equity.

This is a five-year programme and, to an extent, will be dependent on where the opportunities are during that time, but as a broad guide, we will probably spend:

- Around £2.5 billion on gas for the UK market, which may include some spend on LNG
- Up to £750 million on UK power
- £750 million to £1 billion on gas and power for our international businesses
- £750 million for renewables, in line with the guidance that we have given you previously

Bringing any of these opportunities to fruition takes time but I am confident that we will have more progress to report when we present our full-year results next February. Investors can be assured that our strong financial disciplines will continue to apply and we will only invest where we can create value.

Financial Overview

Phil Bentley, Group Finance Director

1. Financial Highlights

I will start with the high-level financials and then take you through the key value drivers in our business units that underpin today's results.

Continuing business turnover, excluding Accord, rose by 3% to £6.3 billion, with particularly strong growth across British Gas more than compensating for lower revenue in North America. Operating profit reached a new first-half record at £763 million, with operating margins up by 1 percentage point to 12%.

Our high interest cover reflects our under-gearing, which we are addressing both through increasing returns to shareholders and higher levels of investment. Our effective tax rate has risen by 1 percentage point to 29% as we have now used up previous tax losses in

North America. We do, though, expect our ETR to remain below 30% for the next few years.

Earnings are also at a record level, up 9% on 2003.

Which business units drove this record performance? Clearly, British Gas, the AA, and Centrica Storage were the main contributors in the first half, with the disposal of Goldfish also having a positive year-on-year effect and, as Roy said, One.Tel is now firmly profitable. However, on the negative side, we have seen falls in both Centrica Energy and North America. Let us look at the detail in our key operating units, starting with British Gas.

2. British Gas Residential

Operating margins were 7.5%. As you can see, operating profits were up by £74 million compared to the first half of 2003. The 5.9% January '04 price rise and the full effect of the 2.5% price rise in April '03 added some £218 million to the bottom line. However, our commodity costs have also risen significantly over the past 12 months. Gas was up by 9% and power was up by 11%, causing a negative impact year on year of £165 million, but compared with market prices that rose 27% and 33% respectively in the same period, you will see we have done a pretty good job of hedging this exposure.

Normally with a January price rise to customers, we tend to over-recover in the first half when commodity prices are lower and our turnover to customers is higher. The Q4 forward gas curves, though, are now higher by some 38% for gas and 20% for power than for the average for the first six months. And so, at current retail tariffs, we would expect to see a loss in energy in the second half and this is something we now need to address with further tariff increases unless the forward curves come off dramatically.

For once, we had favourable temperatures with the key shoulder months of March and April being colder than 2003, adding some £20 million to gross margin in the first six months.

On customer numbers, as Roy showed, whilst we did suffer customer losses in the first half, the year-on-year financial impact was only £3 million, as churn was extremely low during the January and February period when consumption is at its highest.

On the other side, our energy efficiency commitment continues to rise – another £19 million year on year – and we expect a full-year expense of around £75 million, rising to over £120 million in 2005.

Summing up British Gas's performance, when you strip out the commodity and weather, we are growing in our key areas of differentiation – our related products and services – and here we saw a positive year-on-year impact of £15 million, despite the further investments in engineers and process re-engineering. Remember, as Roy said, that these services also improve customer loyalty in the energy sector.

3. Centrica Energy

Turning now to the upstream business of Centrica Energy, as Roy said, equity production volumes were down by 5% on last year as we deferred some production to the second half to take advantage of the higher forward prices. Although this deferral impacted operating profit by £21 million, we do expect it to be recovered in the second half.

However, we did benefit £50 million from selling prices up 11%. Remember the Morecambe Bay contract has a lagging nature compared with the 27% increase in the month-ahead gas market price.

Petroleum revenue tax (PRT) was up £34 million in the first half, a function both of the higher selling prices year to date and the increase in the expected future profitability of gas in the ground, which has the immediate effect of raising the unit of production rate charged in the period.

A major year-on-year negative in the whole of the group's results, £70 million, comes from the Industrial and Wholesaling business performance. Whereas in 2003, when we talked of a 'perfect storm' in generating £62 million of profit, this year we have been hit hard by the four standard deviation move in gas prices compared with much slower sales price increases.

At demerger, we inherited 11 industrial long-term sales contracts. The selling prices for these sales contracts are linked not to gas but to a basket of indices based on a DTI survey, such as PPI, gas oil, and fuel oil, which do not correlate with gas market prices. Against the magnitude and the speed of rise in gas market prices, our pricing escalator has simply failed to keep pace. For example, PPI rose 1.5% in the same period that gas prices rose 27%. Looking forward at these forward curves, we are concerned that the £8 million losses in the first half will increase in the second half of '04 and widen further in '05 if forward input prices do not fall.

4. Other UK businesses

Turning to better news, the rest of our UK portfolio, including the disposal of Goldfish, contributed some £69 million profit improvement year-on-year and Centrica Storage in particular, as you know, should have a very strong second half.

5. North America

Finally, North America. On the face of it, it looks like profits were down some 14% but, stripping out FX and a one-off reconciliation item, underlying profits were actually up 12%. Let me explain those movements.

On FX, year-on-year, the US and Canadian dollars have weakened by 13% and 4% respectively, leading to a negative translation effect of some £3 million.

More importantly, we had a £16 million hit from a 2003 market reconciliation exercise in Texas. Put simply, after 'trueing-up' all of the meter reading, customer numbers, shipped volumes, and all the data that is held by the systems operator, transmission operators and marketeers such as ourselves, after the true-up, consumption by our customers turned out to be lower than we had forecast at the year-end.

We now have the clean data going forward. So, if you strip that out, underlying electricity profits in Texas are actually up by £7 million, with continued organic growth and increases in price-to-beat tariffs, although this has been partially offset by churn in our incumbent businesses. We now have a new management team addressing that in Texas.

Upstream profit was lower by £8 million – that is a combination of lower production and reduced trading activities.

However, Home and Business Services added some £8 million organic growth year on year due to the growth in heating and cooling services, improved performance in the water heater business, and greater control over our cost base. We are also beginning to see encouraging take-up of our proposition for the larger commercial markets.

6. Cash flow drivers

Turning to cash flow in the first half of ‘04, this was once again a period of strong cash generation, with post-tax operating cash flow of £647 million in the first half.

PRT cash paid in the first half was £42 million higher than the same period last year due to payments on account being based on the higher charge, on higher prices, at the end of 2003. Corporation tax (CT) paid was £68 million higher than last year because much of the upstream tax payment in respect of ‘02, which would have normally been paid in the first half of ‘03, was actually settled in ‘02 to reduce the overall upstream tax payable.

As usual at this time, our working capital outflow in the first half is considerably more than the full-year expectation, due mainly to the seasonal decrease in energy creditors, with our lower contractual gas take combined with British Gas’s direct debit customers building up a credit balance after high consumption during the winter months. We expect the incremental working capital requirements for the full year to be in line with previous guidance at around £100 million.

Capex and acquisitions were materially higher than last year with the completion of several deals in the first half, as Roy mentioned, leaving free cash flow before dividend of £350 million.

We have declared an interim dividend to shareholders in cash terms of £108 million, 48% up on last year, and, as Roy emphasised, it is not just about increasing our payout ratio. It is also about delivering increased earnings on which the payout is made. There is no doubt that these two features, together with our financial discipline in investment decisions, will continue to drive superior shareholder value in Centrica.

Summary and Outlook

Sir Roy Gardner, Chief Executive

1. Summary

In another challenging period, we have continued to deliver overall a good financial performance. All our UK customer-facing businesses delivered increased profits and Centrica Storage continues to prove its value to the group with a very strong first-half performance. At a group level, operating profit is at a first-half record.

Our balance sheet strength has enabled us to continue investing in our business, building a platform for future growth.

We are progressing the investment in our customer service systems in British Gas and in Centrica Business Services.

We are spending £30 million a year to grow our engineer base and we are investing in the capabilities required to deploy them effectively.

We are managing our workforce through a period of considerable change, whether offshoring in India in One.Tel or process re-engineering in British Gas.

We have invested £99 million of exceptional costs in significantly reducing our ongoing cost base in British Gas and elsewhere in the group,

And we are continuing to strengthen our upstream asset portfolio to ensure competitive cost of supply for our downstream businesses.

Our strategy is to create value for our shareholders and we think we are striking the right balance between investing in long-term value creation, as well as delivering short-term earnings and dividend growth.

2. Outlook

Looking forward, we have been able to largely contain the impact of higher commodity prices in the first half of the year. However, margins for the second half will remain under pressure unless input costs reduce significantly. If that does not happen, then we will have to put in place a retail price increase.

As I said earlier, I am confident that we will make further progress in our upstream asset investment plans.

We will continue our focus on operational efficiency, particularly on initiatives aimed at reducing our costs in British Gas ahead of full implementation of the transformation programme.

We have seen excellent top-line growth in the first half from home services, including telecoms, and also from One.Tel. We need to maintain that momentum and that is another important area of focus for us.

We expect to complete the sale of the AA within the timescales we outlined a month ago and, subject to shareholder approval for the share consolidation, we will pay the special dividend during the fourth quarter. We may also start the buyback programme ahead of the AA completion, dependent on appropriate market conditions. We will deliver on our promise of a 40% dividend payout ratio this year, with a further 25% growth in the dividend over and above earnings in 2005.

3. Conclusions

Value creation and shareholder reward are firmly at the top of our agenda. Our business is strongly cash generative and we have a clear philosophy to deploy our cash reserves to the benefit of investors, whether that be through investment, acquisition, or returns to shareholders.

There is a lot to do in the second half of this year and more challenges to face, but I am confident that our full-year performance will be in line with expectations and will form a solid base for further improvement in 2005.

Questions and Answers

Andrew Mead, Goldman Sachs

First, given the potential tariff increase that you may have in British Gas, maybe this year, and the top-line growth that you effectively get from that, will you still be talking about making an 8% margin in future years?

Second, you mentioned that, from the British Gas transformation programme, you would maybe get towards the top end of the benefit range from the reduction. Can you remind me what those numbers are?

Sir Roy Gardner

The benefits range from £120 million in 2005 up to about £200 million by 2008, and so we expect to be towards the top end of that range, as I said.

Phil Bentley

The point about the 8% is, we set that 8% target in 2002 and since then gas prices have gone up by 50%, so there is no question that it makes it more challenging but we are absolutely committed to that 8% target. Now, there are a number of variables in the equation before we get there. We have to look at what our competitors are doing in terms of the impact on churn; we have to see what we can do from our own cost base, if you like, to mitigate the effect of that. We have to see what the curve is doing; the curve is moving, literally, daily and there are some big moves. But, we are targeting on that 8%. How we pass the price rises through in terms of timing and quantum is for us to decide but we are certainly firmly targeting the 8%.

Bobby Chada, Morgan Stanley

Given that, over the last few months, a number of your competitors have already moved prices to varying degrees, could you give us some idea about the impact that you saw on your customer flows after that happened? Perhaps you have not seen it yet.

Secondly, just returning to the cost-saving targets from the transformation programme, if I remember rightly those were in money of the day – that is 2002 or 2003 prices. Are we still expecting to see those savings in real terms?

Sir Roy Gardner

On customer numbers, I think you saw from the chart that we have started to move more towards a normal pattern of customer churn and it is probably too early to determine the impact of our competitors' price increases, but at the moment it looks as though it is normalising.

In terms of the cost of our programme, I do not believe that it has increased materially from the numbers we gave you before.

Mark Clare, Managing Director, British Gas

In terms of the overall transformation programme, which is obviously in a number of different parts, as has already been said, we are continuing to make good progress, both with the implementation of Jupiter and the Hestia programme, which is the work management system for our engineers. The costs of that programme are very much in line with the indications we have given before.

In terms of the benefits, we are already seeing progress being made. We have seen reductions in headcount that we have already announced, and that is obviously part of it. The technology implementation is on plan and we are very pleased with the progress that we are making there. The re-engineering that we are doing, which has partly driven those cost reductions, is also on plan. On Roy’s point that we will be towards the top end of that range, we are now very confident of that.

Simon Flowers, Merrill Lynch

You highlighted the upstream position on gas, that Morecambe had held up a bit better, yet there is likely to be a bit of a fall in 2005, and I think your detail talks about one of the other fields having a write-off against it. In the first half of this year, you had an equity hedge of just over 40%, so it suggests in 2005 that you will have a much lower equity hedge. Your strategy upstream seems to be more medium term – you are looking at LNG and projects outside – and I just wondered if you would feel a bit nervous about your equity hedge position for 2005 if you find a similar rising-price environment.

Jake Ulrich, Managing Director, Centrica Energy

If we were to have another move of 30% or 40% in wholesale prices, I think everybody would be nervous. We do not expect that. As you are aware, we should see the Isle of Grain project coming onboard in the first quarter of next year. When we look at the supply-demand balance in the UK – and we have a stack model where we look at all the fields and we look at what we believe to be all the major demand-side influences – things are pretty tight this winter – December, January, February - but prices seem to be overcooked in the shoulder months and certainly in the summer.

I do not think LNG is a medium-term approach either. To underwrite the projects, and to invest in North Africa and the Middle East, we are talking 15 to 20-year horizons and you do not see much economic value in the first several years of that, so clearly we are focused on the long term here.

To get back to your point, I think ‘05 could be a pretty interesting year. I do not think the prices beyond the first quarter are necessarily real but there is certainly a premium built into this market and there is a lot of concern about whether these new projects will deliver.

Iain Turner, Deutsche Bank

When you look at what has happened with the retail business this year and the high wholesale prices, and what has happened with the wholesaling profitability, does it make you think about changing your approach to risk management compared to how it was set

out when we had the meeting at Cazenove? The question is in terms of the hedging and how you think about your hedging profile going forward.

Phil Bentley

The simple answer is no, but there is no doubt that we have had significant moves in 'unhedgable' exposure. That was always there. If you look at the market, we have to buy forward usually on a month-ahead basis and if you are long, you are going to get cashed out at systems average. If you are long, it is usually because it has been warmer and, therefore, you have probably been cashed out at a loss.

We have certainly seen a couple of occasions where that has happened, certainly in January of this year, and obviously if you are short, that is because it has been colder and prices have risen. The ideal of a perfect hedge is just not there. We have seen the change in the market there but I do not think it is going to change the way we approach the way we wholesale, and the industrial sales contracts have got time to run on them, I'm afraid.

Jake Ulrich

A key point here is, if you look at the industrial-commercial contracts, a lot of those are legacy contracts and clearly we would not do PPI or fuel-oil or gas-oil based escalators going forward. We are trying to keep everything on a more 'hedgable' basis, whether that be some type of gas-linkage. In essence, we have changed since these contracts were put in place.

Simon Edrich, Commerzbank

Could you talk a little bit about the return on invested capital – your return targets for the new investment programme?

Phil Bentley

We have given guidance before on that and I do not think they have changed in any way. On renewables, we are looking at post-tax internal rates of return (IRR) of between 12% and 15%. We have said that in the UK, UK gas investment is probably nearer 10% post-tax. As we look further afield, if indeed we have to, I think we would be looking for a higher return, frankly, from that. If you look at something like Rough, that has given us 17%, so they are your ranges and we do not see anything different.

We are certainly not changing our target and our hurdle rates to spend the money quickly. That is certainly something we referred to at the beginning; financial rigour has not changed in that respect.

Martin Brough, Dresdner Kleinwort Wasserstein

You mentioned a little about the lag effect on Morecambe and the other gas production, but Morecambe in particular. I know sale prices are moving around a lot in terms of the forward curve but, as things roughly stand, how much lag would there be into 2005?

Roughly, what kind of sale price would you be looking at for the gas production business in that year?

Jake Ulrich

It is a quarterly price, with a six months lag, and off the top of my head, I would say it is going to be up somewhere in the 10% to 12% range. I would have to come back to clarify that. It is clearly going to keep moving up and even after the forward prices start to come off, that lag will continue for a little while.

Andrew Wright, UBS

I have a question on weather: could you tell us what the weather effect was relative to normalised weather? Also, looking at my model, it appears that five out of the last six years have had below-average consumption and slightly warmer than usual weather. Are you reviewing your view of what normal weather is when looking into the future?

Sir Roy Gardner

We do review our view of the weather because we have a 10-year rolling average, so it is always picking up the latest impact of recent weather. I think Phil outlined the impact in the first half.

Phil Bentley

As we have said before, the pattern is as much of an impact in terms of when it is warmer and colder as it is in terms of the absolute period. This year, we have been very much in line with seasonal normal temperatures, so you are really looking at some of the patterns around that, the key what I refer to as the shoulder months, the time when people are thinking of turning the heating off but do not if it is that bit colder. That is usually March and April, depending on where you live in the country and your frugality. March and April was colder and people kept their heating on longer and, against the previous year, that was up about £20 million for us. The other thing we do is we budget less than seasonal normal temperatures and, so for our own internal planning processes, we have an inbuilt conservatism in our budgeting.

Jason Goddard, CSFB

You talk about your expectations regarding the production from Morecambe being down 25% or so next year. Is that a technical limitation or is there flexibility to increase that significantly if needs be?

Secondly in terms of your confidence about the build and the timing of all the import infrastructure for gas into the UK – LNG and pipelines – has the confidence increased or decreased since the charts that you showed at your conference last year?

Sir Roy Gardner

On the first one, I think I made it clear in my presentation that we do have the ability to turn it up and turn it down, and we do in 2005. In terms of our confidence in investing in infrastructure outside of UKCS, I am feeling a little bit more confident. I did say that I believed we would be able to report on further progress before or when we announce our results in February.

Jake Ulrich

On that point, BBL line has received all the requisite approvals and we have already made our nominations, so that seems to be proceeding along track. There was some question, I know, in the spring due to some of the issues around the exemption. We certainly see the Isle of Grain project moving forward and we expect to see that on early next year. Every indication that we have received is that it will be on time in Q1 and they are going out for tender for an additional five BCMs, so we are fairly optimistic that there will be a significant increase in the capacity there. You are well aware that the Langeled line is coming into our Easington terminal and that work has already started. A number of these projects are looking fairly solid at this point.

On Morecambe, you are well aware that we gave guidance that we basically expect a 10% drop per annum in the production and we have pushed it pretty hard in the last two years. What happens now is there is obviously a limit to our production level. We are pretty much tapped out on the winter months and the shoulder months, and it becomes a question of how hard we would want to produce in the summer period. However, we will obviously not be able to maintain the levels of the last year. This is just getting us in line with the decline that we had previously indicated.

Richard Gray, UBS

On this gas price increase question, does it not make sense to get a gas price increase in at the end of the summer, if for no other reason than, psychologically, it is a rather bad and divisive tradition to have to put up gas prices in January, when the newspapers can accuse you of freezing old ladies?

Sir Roy Gardner

There is never a good time to put up prices, to be honest, and we won't let media comment dictate to us when we believe it is right for the business to put up our prices. As we said, it is something that we are keeping under constant review and, if it is appropriate, we will act decisively. Beyond that, I am not going to say anymore.

Robert Marshall-Lee, Newton Asset Management

Following on from Morecambe, can you give us a feel for whether the swing is expected to decline in line with the production or whether you have a bit more in terms of the ability to match the curve?

Jake Ulrich

You have to understand that we run Morecambe at its very maximum during the high-demand periods. We are not using the same degree of swing that we used two or three years ago and that is just a fact. It has become an important part of the portfolio and we are trying to maximise these current prices. If we did see a significant drop in forward prices, then we would re-run the maths and determine whether we wanted to keep more flexibility, but at these prices, delaying production to eight, nine or ten years out does not make sense. Flexibility is down but that is by design.

Ian Mitchell, JP Morgan

On the US, you talk about organic customer growth and, obviously, upstream investment. Have there been any regulatory changes or do you see any that might allow customer block acquisitions again in the near future?

Sir Roy Gardner

There are still odd opportunities to acquire small customer blocks but there are no major opportunities as we have experienced so far in the three years we have been in North America.

Deryk King, Chief Executive, Centrica North America

That is absolutely right. We were planning forward on the basis that there will be no significant regulatory change, either positive or negative, affecting the residential sector. The regulatory environment for the larger customers is more positive and we are seeing very significant growth in not only demand that is free for competition, but also switching. By next year, just to pick an example, in the US electrical sector, a number of commercial-industrial customers who will have switched supplier in competitive markets, their load will exceed the total UK load in all sectors.

Peter Atherton, Citigroup Smith Barney

On the £2.5 billion for upstream investment for the UK gas, presumably that gets you up to about the 35% to 45% of equity. What would be the ongoing rate of investment required to sustain that level over and beyond the £2.5 billion that gets you there?

Second, when you are investing outside the UKCS for gas assets, will you only invest in fields and in facilities that are directly related to getting gas into the UK or would you consider investing in the wider market that would provide a circuitous route or a circuitous hedge against the UK market?

Finally, you talked about strengthening the management team in Texas – could you take us through what errors, mistakes, and failures that the old management team in Texas made?

Sir Roy Gardner

In respect of the ongoing investment to maintain that £2.5 billion, it is something in the order of £300 million a year.

Basically, our investment outside the UKCS will be in facilities to enable gas to be transported to the UK.

Deryk King

Let us say here and now that our investment in Texas has been a great investment. The shareholder returns we are reaping, in particular from the acquisition from AEP at the beginning of last year, are extremely strong. But we are always of the view in this company that we can do better and I have not been satisfied with the rate at which we have built up the organic side of the business, and our customer losses have been too high for comfort in the franchise, the incumbent side of the business.

I do not want you to think we are replacing the whole Texas team lock, stock, and barrel because it is actually a good team that has performed pretty well, but it does need some strengthening. We strengthened the management at the top of that group, we have strengthened the financial management in view of some of the issues that Phil talked about earlier, and we are planning also to strengthen the sales and marketing teams there.

Roger Carr

Can I just add to that? I was with Deryk last week and his team. This is a very strong core team that has been strengthened around the edge, and the enthusiasm and commitment of the people to build on what is a very strong base is very high. I was very encouraged by it so you should take that away with you.

Thank you all very much for your questions and for your attendance today.