Centrica
Trading Update
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Overview

Phil Bentley

Finance Director

I. Preamble

Good morning, everyone. I am Phil Bentley and I am here with Kieran McKinney from the investor relations team. Welcome to Centrica's first trading update. As we said in the statement this morning, from now on we intend to do this as a regular process prior to going into close periods. Hopefully, you will find this helpful. I will start by making a few remarks about the statement, picking off a few key themes, before we turn it over to questions and answers.

II. 2004 Performance

Starting with 2004, overall we are in line with market expectations. Many of the things that we highlighted in the first half have continued in the second half. Obviously, the key issue is the wholesale markets, particularly around gas, but, as you will see, we have had a good performance from our own upstream business, as well as Centrica Storage.

In North America, we have had a strong second half and the performance in both Texas and Canada, which have some signs of further growth, means we believe that gives us some upside to come. We have continued to invest in upstream assets as well.

Overall, we are confident of delivering double-digit year-on-year growth in earnings. For clarity, I think the market consensus for 2004 is around £1,216 million we believe, earnings around £836 million, pre exceptionals and goodwill and EPS, on a similar basis, just a touch under 20p at 19.8p.

There have obviously been major movements in wholesale gas and electricity prices: 32% and 18% in gas and electricity compared with the second half of last year. We have had incredibly volatile markets, as you are aware. On 5 October, we saw January 2005 prices at 80p per therm. If I look today, January 2005 is at 37.6p and the day ahead is at 31p. Therefore, we are certainly seeing a significant softening in the market and, in the long run, Centrica has always predicted that these prices were probably somewhat overdone. On a like-for-like basis, Q4 2004 versus Q4 2003, is still 32% higher, but we have flagged that we have hedged our positions out and do not have any more exposure. The market-swung basis – in other words, taking our extra winter demand and weighting that higher than summer demand – is about 28p for 2004, which is up year on year just under 30%.

III. British Gas

British Gas customer numbers is obviously a key question on people's minds. To the 7 December, we have lost some 630,000 customers. Obviously, that is a churn rate that is significantly higher than the first half of the year, where we were churning at around 11,000 a week. In reality, it is fair to say that it is where we expected it to be, recognising that we did a 12.4% price rise in

September on the back of an earlier one at the beginning of the year. The key question for us is the rate at which churn will come down to normal levels. There is a lag in the system; we are seeing churn starting to soften now and, as you know, a number of our competitors have followed us in terms of pricing. We certainly think that Scottish and Southern Energy may well go in the first quarter of 2005. In terms of the outlook for customer numbers in 2005, I will come onto that when we talk about 2005.

We have not really touched on British Gas Services in this statement because we are preparing a presentation to the market next week, but we are pleased with the progress we have made. Turnover growth has continued at a rate in line with the first half and, as you know, the business model scales very effectively so turnover year-on-year delta translates to profit year-on-year delta that is significantly higher. We are quite pleased with the performance there.

IV. Upstream

Turning to upstream, in the first half production was slightly down on 2003, but we expect overall to be flat on 2003, i.e. higher in the second half than the same period last year, and we will obviously benefit from the higher prices.

On the industrial and wholesale contracts, we have tried to give some further guidance there. The price that we get for the gas that we sell is linked to indices that do not correlate to gas on these legacy contracts. Just to give you a sense of that, the 2004 prices that we get will actually be lower than 2003, even though wholesale markets have gone up some 30%. In terms of guidance, Morgan Stanley have modelled this at around a £20 million loss for 2004 and a £100 million loss for 2005. That is probably a good stab at the position we have today.

On storage, there has been good performance there. The 2004/05 storage year prices were up some 70% and much of that will flow through into the significant uplift in profits in 2004.

V. Other Downstream Businesses

On the other pieces of downstream, CBS is, in essence, really flat year-on-year. We are not expecting a big pick-up there but we do include in those numbers the launch of a telecommunications product, which is slightly negative in the first instance as a start-up. Actually, the energy piece of CBS is slightly up.

We think we are making good progress with One.Tel. We are above market expectations; I think market expectations were about £9 million and we should beat that comfortably. We are getting the cost efficiencies out of moving some of our operations to India, which I will touch on more in a second.

In North America in 2004, you will recall that in the first half, we had this Texas reconciliation, which was effectively overbooking profit in 2003, and this led to a reversal in the first half of 2004 of £16 million. We have also been hit by the FX as well because, obviously, translation is going against us. Those two together in sterling are about £22 million, so to end up slightly ahead in 2003, given a £22 million one-off hit, is quite hopeful for the future.

VI. Financial Structure

We have now purchased some 67.4 million shares at an average of just over 242p and we will continue to operate in the market. Again, we are confirming our commitment to a dividend payout ratio on earnings of 40% this year and 50% next year.

There is a cryptic comment about UK accounting standards but IAS39 is perhaps something that there will be some questions on, but it is still to be landed. That is under normal accounting.

VII. Investment Progress

We are continuing to focus on our strategy to support our growth in downstream with our upstream investment. We have made some progress in the southern North Sea, adding Horne & Wren, an onshore wind farm, and we have exercised our option to take the opportunity to develop one of the two fully-consented CCGT sites.

You will have also seen earlier this month that we completed our second power station acquisition in Texas, at about 50c on the new build dollar, and signed up our first LNG contract, so there is quite a lot happening upstream.

You may have seen the appointment this morning of Jake Ulrich, our head of upstream, to the board, clearly signalling where some of our focus will be going forward.

As the comment says, recent upstream activity confirms our view that patience, financial discipline and consistent view of market fundamentals will be key. That is a cryptic comment in respect of Ormen Lange and I think most people would recognise that we were in the pack in terms of where our competitors were, but there was an incredibly aggressive bid for that and we were very happy to sit on the sidelines.

On the other downstream businesses that we have bought, we are actually very pleased with both Dyno Rod and Telco Global in the UK, which we believe will be significantly up on the acquisition case. In the latter, there are certainly far more synergies that we expected.

In North America, RSG is in good shape and looks a very good business to us. The automation and control businesses are really enhancing the business offer there, which is actually one of the key drivers in North America next year.

VIII. 2005 Outlook

The big issue is what wholesale gas and electricity prices are going to shape up to be. On a market-weighted basis, we are looking at gas prices to probably be up some 23% next year and electricity up 20%. In light of the churn, we are looking at whether we should immediately pass through those price rises or phase them in over time. The statement says that in 2005 it is not our intention to pass through immediately those increases. We have to weigh-up our overall impact of churn with the drive to hit the 8% margin next year. Certainly, what we are indicating now is that we are pushing hard on cost reductions but we have decided that we would not push forward and fully recover the British Gas gross margin squeeze in 2005. Thus, the 2005 margin will be similar to 2004.

I think market expectations for British Gas in 2004 are about £320 million; our turnover will be higher because we have put pricing through but, obviously, percentage margin will be around the same.

If we see a more stable environment emerging throughout 2005, it is our intention to win back more customers than we lose. If you look at our history, apart from the blips on high volatility and big pricing moves, that is what we have done. We have always added more electricity customers than we have lost in gas, so we are still convinced that an 8% target is both appropriate and achievable. In a stable environment, we think we would get there with some comfort. Part of our confidence there is the transformation programme. We are taking action to deliver the scale benefits. As we have said before, we have not leveraged our scale as well as we could have done because we have not had the systems and processes to support that, but we are well on the way now.

The SAP billing is going through test; there is a slightly higher cost there but that is really the cost of adding the staff backfill. We know from doing the Siebel rollout that it takes longer to train people fully. We have to take them off the front line and so the replacements are in the trenches, if you like, for longer and that gets charged to the programme. We announced earlier that Siebel and SAP was delayed but we are still on track to that revised programme. We are confident that whilst the benefits of that side of the transformation have slipped slightly, the overall transformation programme is on track for 2004/05. If you follow that logic through, you would expect us to start to see more benefits coming through as we pick up the Siebel and SAP savings in 2006. Market expectations for the transformation benefit are around £100 million to £120 million in 2005.

Gas production is one where we flagged to you that 2005 could be down some 25% year on year. We now think it is more likely to be around 15% down. That is an assumption of pumping harder when prices are higher, but there is also some self-help going on there. We are reorganising how we take some of the water out of the gas on some of the remote platforms at Morecambe, and we are also going back into some of the pay zones, re-fracturing those, and seeing decent flows. Therefore, reservoir pressures are performing probably a little bit better than we expected and indicated to you before.

The one issue there in terms of mix, which I will come back to when I wrap up, is that our upstream profits are taxed at 40%. Whereas we have given an indication of slightly south of 30% for our tax rate, obviously making more profit upstream puts a negative impact on that, and we are flagging now that tax will be around 33%.

In terms of storage, we sold out the non-Centrica storage, (now 84% of the 2005/06.) That is good growth.

We are seeing good growth in our operating profits in North America and, in terms of currency, we have done a plan at $1.80; 10c worse than that will probably take about £5 million off our North American profits, but we think we are in good shape there for future growth. Our services growth is strong as well, as you will hopefully get a flavour of next year.

IX. Summary

In summary, wholesale prices are a key issue. We are not expecting gross margins to recover fully but we are saying that a significant proportion of that will be offset by the high gas production, storage, and growth elsewhere, such that the aggregate will be in line with current consensus. I think the consensus there is about £1.33 billion and earnings are at £900 million.

The point about the tax-mix effect there is that you effectively need to adjust down the earnings by the delta on the tax rate on the annual earnings. I think there is probably about £45 million to come off the earnings number because of the higher tax.

We are on track for double-digit EPS and profit growth. We are taking action to deliver the scale benefits out of British Gas; we are delivering growth elsewhere, which will be strong, and we are addressing our strategic question of adding attractive assets to underpin our business model and that will continue.

Questions and Answers

Ian Mitchell, JP Morgan

I just wanted to ask quickly about one number that you gave us at the upstream presentation a year ago. This was the £62 million impact on the downstream that you have from a 1p per therm. Given that Morecambe production and, therefore, the hedge is down next year, can we just scale up that impact by the decline in Morecambe production, or is it a bit more complicated than that? Can you give some guidance please?

Phil Bentley

I think I am right in saying that was the gross number before the offset. The guidance we give – and it still holds – is an overall net effect of £40 million to £50 million per penny a therm. It is complicated by these industrial and wholesale contracts that we have and it is obviously a lot more complicated than that, but the guidance that we have given is within those boundaries that we said before.

Andrew Wright, UBS Warburg

I have a question about the assumptions that you had for the gas price when you announced the rise in prices back in August of this year. Presumably at that time, the price increases that you were implementing were designed to achieve the 8% net margin. To what extent have gas prices moved now? To what level do they have to fall before you feel that you are back on track and the gas price equates to the level of price that you had assumed at the time of the retail price increase in September?

Phil Bentley

A point of clarification there: we always have left open the opportunity to price in September. If you recall, we said we would like to move to a more regular pricing around September, so the issue about Q4 and how we dealt with the balance in Q4 was always out there in our minds because we were pricing for a year in September. However, it is not a simple question to answer in terms of what hedges we have in place and what is the effect of Morecambe. You have obviously seen prices rise since September. January hit 80p, and you are layering in hedges to a point, but at a point you quite quickly stop layering in hedges. We have not been layering in hedges for some time, quite frankly. Now the market has fallen back so actually the market is probably back to where it was against that September announcement – it was actually August when we planned the price rise. At the time, though, Morecambe profits are straight market-related and lagged market-related, so the downstream is paying for Morecambe, including the high prices that we have seen over the forward turbulence through September to November.

Andrew Wright

Are you saying that, given where prices are now, we are simply now looking at a transfer of profitability from the downstream business to the upstream business and that your external cost of gas is now back in the realm where it was when you assumed the prices would rise back in August, or are there other impacts?

Phil Bentley

I am saying that it is still probably a little bit higher and the market needs to fall a little bit more. Q4 yesterday was trading at 36p. We will have to see how that plays out; that probably still needs to come off a little bit more. Just as a comment on the trading liquidity in the marketplace: a lot of the trading is in the short-end, which is why you have seen this winter come down significantly – January is now trading at 37p. However, there has been less liquidity in the summer months, so relatively they have not fallen as much. Similarly, there has not been a lot of trading out in the winter 2005 period, which is trading at 40p, and we still think, as you get Isle of Grain starting to take shipments in the first quarter of next year, as liquidity improves, we should see that come off a little bit more. We are still hopeful that we will see some softening in prices but our outlook now is based on how we see the market today.

Iain Turner, Deutsche Bank

Can I just ask about the breakdown of the customer numbers between gas and electricity and whether you are losing electricity customers as well as gas customers?

Phil Bentley

We are at the moment and that is one area that we are focusing on because losing gas and winning electricity has been our story. It more or less breaks down to three gas to one electricity, so that is an area that we are focusing on in terms of our sales activity in 2005. We have launched a couple of products, which are going very well. We have a three-winter dual fuel capped price, which we are selling at the doorstep now quite successfully. We have an electricity-only tracker production – in other words, capped at the top but it tracks down if prices fall. That is targeted at electricity-only in the REC areas. In Scotland, we have trialled a telephony offer on the back of a capped price with cheap telephony and free weekend calls. That has gone well and we are rolling that out nationally. There are a number of things, obviously, that any management has to do to respond to the situation that we have. We have products out and, as I said at the outset, we would be disappointed in 2005 if we have a net loss of customers.

Martin Brough, Dresdner Kleinwort Wasserstein

Does managing to bring forward some of the gas production to 2005 have any impact on 2006 gas production? I know it is a fair way out but should we expect slightly more of a step down in 2006? On the IT, are you still intending to send out new bills under the new system from May?

Phil Bentley

In terms of the bills, yes. We will roll out a pilot and then we will scale that up as we go forward.

On gas production, we have been forecasting decline since 2002 and we still have not declined. We have always seen an element of out-performance from Morecambe Bay in particular. I think 2006 will come down; we wanted to give you the same guidance we have given before, around 20% to 25%, but as we get closer to it, we will see what we can do and see what efficiencies we can eke out of it. We are quite pleased to get what we can out of it in 2005.

Richard Budgett, Dresdner RCM

Just for clarification, you said that 2005 operating profits are going to be in line with consensus – does that include an assumption for further tariff rises in 2005 for gas and electricity?

Phil Bentley

That is a good question. The answer is that it will depend on where we are in Q4. We have certainly put a place-marker in terms of a close-to-inflation routine adjustment based on the curve today.

Richard Budgett

Therefore, it does include an assumption for further tariff rises in order for you to achieve operating profits in line with consensus.

Phil Bentley

Yes, around a close-to-inflation rise. Recognising that we have a long way to go before we get to Q4, if the Q4 curve comes off, which is our expectation, we will not need to do a price rise. It is not a big part of the numbers, let me put it that way.

To be absolutely clear, we have our own models and we use the market curves for ensuring our plans are in line with the market. If we saw a Q4 turnout where it was, we would probably need to tweak it at an inflationary level, not in terms of wholesale prices but a normal 3% to 4% type of tariff. We hope that will not be necessary as the market liquidity comes in nearer the time and softens the market.

Peter Atherton, Citigroup Smith Barney

First, on the US business, can you give us a feel for what has been driving the improvement there in the second half? Second, on the wholesale gas market business, there has been an investigation by Ofgem and the DTI are also looking into it – are you concerned about the overall functioning of the wholesale market at the moment?

Phil Bentley

I think we are seeing a few positive green shoots there in the business.

We are winning net customers in Texas now. We started with a big incumbent and a very small organic, and now we are adding more organic and holding on to the incumbent, which is going well. If you follow the curve over there, you will see that we have raised our prices on the Price to Beat tariff, as have Reliant and TXU. TXU have already used their two bullets, as it were, this year and they have gone out and said that they are going to price up again on 1 January. That is good for us because we have locked out quite a lot of the exposure through hedges and it will mean that we will organically be able to attack in their area. We do not see the need in our Price to Beat tariffs to push on any higher. That is in quite good shape.

We have never talked a lot about the services business in Canada. We are talking to you about services in the UK next week, but we are planning a North American teach-in, probably early second quarter next year. The Enbridge Services business that we have bought is a very good business and we have been able to take quite a lot of cost efficiencies out of it. It is beginning to pull-through some decent growth in services, in heating and cooling insurance products, and also pulling-through some gas growth now as well.

As you know, the electricity market is basically capped out at the moment and there is not much we can do about that. Customer numbers come off there through attrition, frankly, and people moving house, but overall Canada is looking quite strong.

The other side is B2B, where we have added this capability of energy advice instrumentation controls in the C&I market. On the back of that, we sell through some quite chunky contracts. For example, we have just signed up the University of Calgary; we have signed a big contract in Texas – very large indeed – that runs 75 municipalities in Texas for all their municipal requirements; we have signed up Toys 'R' Us; Fairmont Hotels; CIBC; and the Royal Bank of Montreal. These are big accounts and the energy advisory piece is a key unique feature that allows us to pull-through the commodity. We certainly have some pretty aggressive plans there for next year and the team seem very much up for it.

Peter Atherton

What about the current functioning of the UK wholesale gas market?

Phil Bentley

We have said that we will be entirely transparent and turn over all our information to Ofgem. One of the comments has been in respect of the Sean field; we pay a very large per annum option fee to lift from that whenever we wish to, but obviously we only lift when prices are above the strike price. We were lifting last year and we stopped lifting when the prices fell, and that is part of the investigation. Clearly, we are very comfortable in showing why we stopped lifting from the field.

Commercially, all the decisions we take can be entirely justified and we welcome any enquiry that Ofgem bring. We are certainly calling for a greater transparency from other producers.