Centrica

Preliminary Results for the Year Ended 31 December 2004

24 February 2005

Opening Remarks

Roger Carr

Chairman, Centrica plc

I. Preamble

Good morning, ladies and gentlemen, and welcome to this presentation of Centrica's 2004 preliminary results. As usual, Sir Roy and Phil will make the main presentation, but I want to start with a few opening remarks which highlight some of the successes of 2004 and the challenges that remain for 2005.

II. 2004 Review

1. Highlights

2004 was a key year for Centrica's strategic development with the sale of the AA at an attractive price and our decision to refocus on energy and related home services. It was also a key year for our shareholders, as we delivered on our promise of increasing the ordinary dividend to 40% of Group earnings, paid over £1 billion in special dividend and also embarked on a significant share buyback programme.

2. Financial Performance

Overall, our 2004 financial performance was good. This was delivered against a very difficult background, not just for Centrica but also for the energy industry as a whole. The performance we are able to report today is, I think, a testament to the skills and ability of the management team, led by Sir Roy, which in the face of really unprecedented wholesale price volatility and consistent competitive pressure, delivered record results. Throughout the year we have maintained our commitment to customer service, cost control and operational efficiency. We have been disciplined in our consideration of investment opportunities and prudent in acquisition expenditure. These principles are at the very core of our business and will remain so in 2005.

3. Customer Loss

Underneath the financial results, however, the rate of loss of customers in the second half of the year was clearly a disappointment. Addressing this is one of the key challenges for the management in 2005. We are determined to arrest these losses by sharpening our competitive edge, aggressively managing our costs and vigorously marketing our wide range of products and services. When Roy makes his presentation, he will go into more detail about the action plans that are currently being implemented.

4. Board Structure

I said in July that we would continue to review our Board structure to ensure that we have the right mix of skills and experience, appropriate to our position as an international energy provider. During the year we appointed two new non-executive directors: Mary Francis and Paul Rayner, who bring with them a wealth of experience, stability and valuable insight. In line with our increased emphasis on energy, we have also appointed Jake Ulrich, who many of you do know, as an executive member of the Board with effect from the start of this year.

III. Summary

With this clarity of focus, the commitment to managing our costs, very strong financial discipline and the skills of our management team and Board, I am confident that Centrica will continue to deliver shareholder value. I am now going to hand over to the team. First, Phil will go through the 2004 financial results, after which Roy will talk more about the strategy and the outlook for 2005. As always, we will aim to leave time for questions at the end. We have Mark Clare, Jake Ulrich and Deryk King here from the management team to supplement Roy and Phil in the question session.

I will now hand over to Phil.

2004 Financial Results

Phil Bentley

Group Finance Director, Centrica plc

I. Preamble

Thank you, Roger, and good morning everyone. As usual, I will cover the 2004 results before Roy concentrates on the outlook for 2005. I will start with the headline figures for the Group and then take you through the key year-on-year movements in our main business units.

II. Headline Figures

Turnover for the continuing operations, excluding Accord, rose by 9% to £11.8 billion, largely due to pricing and Home Services growth in British Gas, where turnover was up by some £700 million. Operating profit and earnings reached new record levels, up 16% and 18% respectively, with EPS up 19% at 20 pence per share. Over the last five years, Centrica's EPS has enjoyed 20% compound annual growth. As previously flagged, our effective tax rate was up by one percentage point at 29% and, as we indicated in December, we expect this to rise again in 2005, reflecting the increased contribution from both upstream and North America. Our step change in the ordinary dividend, up 59% at 8.6 pence per share, reflects our continued confidence in the Group's future cash flows.

III. Operating Profit Analysis

1. Overview

This is a detailed breakdown of the Group's record £1.2 billion operating profit. With the exception of Centrica Energy, profits have increased across all of our business units. Let me take you through the detailed movements in the larger units, starting with British Gas.

2. British Gas

Operating profits of £337 million were up by £131 million compared to 2003. The two price increases in the year generated an extra £593 million of gross margin, against a commodity increase of only £366 million. Our cost of gas rose by only 12%, compared with a demand-weighted 29% rise in the traded market, the benefit of our upstream assets, our procurement slate and our particular hedging activities. Remember, we had also seen a 29% year-on-year rise in the wholesale gas price in the second half of 2003, so we did have some catching up to do in 2004. Although British Gas margins increased by 1.6 percentage points to 4.9%, commodity price volatility and the high 4Q05 forward prices means that we are not yet at an acceptable and stable level of supply margin. Our energy efficiency commitment continues to rise, with another £27 million year-on-year to £88 million. 2005 anticipated costs are around £104 million.

The gross margin impact of the lower customer numbers was £19 million, as most of these losses arose towards the end of the year. This was more than offset by the £21 million positive impact of weather mix. Despite the fact that 2004 was slightly warmer than 2003, it was colder in the summer and in the transitional months when heating systems are turned off and on. Our energy operating costs base rose in the year by £82 million, with higher investment in systems and improved processes, together with increased debt provisioning, pending improved industry data flows. As Roy will touch on later, the savings from the British Gas transformation are clearly on track and will come through progressively as we make further cuts in our overall headcount and cost base, and as we stop using the old legacy systems and processes.

3. Home Services

Finally, our Home Services business continues to perform well, with a 13% increase in operating profit to £95 million. Sales increased by £96 million but we have offset most of this with our continued investment in growing our engineer workforce by 12%, at a cost of £29 million, and with non-recurring costs associated with laptop replacement and the new engineer deployment system. To sum up British Gas: our price rise in September, whilst regrettable in driving churn, was the only decision we could take to pass through the wholesale cost increase and restore profitability.

4. Centrica Energy

Turning now to the upstream business of Centrica Energy, with equity production volumes similar year-on-year, higher gas prices at Morecambe and £149 million operating profit before PRT. In line with previous guidance, we expect 2005 production from Morecambe to be 15-20% lower than in 2004, with 2006 lower again by around 25-30%. Although not a big year for gas acquisitions, our Statfjord investment added some £20 million before PRT. Not surprisingly, PRT was up £80 million overall, reflecting both higher prices in 2004 and increased life-of-field profitability.

5. Industrial and Wholesaling

Industrial and Wholesaling (I&W) saw a reversal of £129 million, compared with a very successful 2003, and lost £38 million in 2004. Although we have made good profits on I&W in the past, it is difficult to hedge these legacy contracts when you consider that our overall contractual selling price fell last year whilst wholesale gas prices increased by 29%. At current forward prices we expect the reported losses for the I&W segment as a whole to double in 2005 and remain at this level in 2006, before breaking even in 2007 as the forward market falls and our sales prices reset upwards. Finally, the extra £9 million of operating expense here reflects the increased resources now addressing our upstream investment opportunities. For reporting purposes, we include the total overhead costs of running Centrica Energy in the total I&W result.

6. Other UK Businesses

a. Centrica Business Services

Centrica Business Services produced a very encouraging result, up £13 million year-on-year to £64 million. Although the contract sales market in electricity appears to be maturing, our retention rates increased to over 88%. We also saw some upside in the last quarter of the year, as wholesale prices for gas softened.

b. Centrica Storage

The continued improvement in Centrica Storage should come as no surprise. As we forecast, summer/winter pricing differentials continued to widen in 2004, with average SBU prices up by 58%. We have now sold 100% of the storage capacity for the 2005-06 year, again at a much higher average price than the previous year. We expect 2005 profits to significantly exceed the £69 million profit we made in Storage in 2004.

c. One.Tel

2004 was also the year when One.Tel made its first material profit contribution of £16 million, up £12 million year-on-year. Although organic customer growth is challenging, the acquisition of Telco Global and major cost reductions following the transfer of call centre activity to India contributed to our success. At the end of the year we had over 1.7 million telephony accounts with an annual turnover of £280 million across Centrica.

7. North America

Turning now to North America, to give a better year-on-year comparison I have adjusted for the £10 million foreign exchange impact, due to the weaker US dollar, and £16 million in respect of the 2003 revenue true-up in Texas. Therefore, the underlying profit improvement in North America is up 29%. Texas profits at £60 million were up £24 million, mainly reflecting the benefit of the end of the clawback regime in 2003. The £2 million year-on-year deterioration in Canada Energy mainly reflects a full year of acquisition costs in Alberta, selling deregulated tariffs to the regulated base. Home and Business Services profit was £40 million, reflecting improved Home Services productivity and growing momentum in business markets, where turnover was up 62%. We see real opportunity for growth in these divisions in 2005.

IV. Change in Accounting Basis

As you know, this is the last time we will be reporting our results prepared on the basis of UK GAAP, as we will be one of the early adopters of IFRS, with our financial year having begun on 1 January. You will be aware of the main impacts of IFRS, but clearly IAS39 is the key issue for us given the complex volume and pricing flexibility we have in some of our long-term procurement contracts. Although we are still waiting for agreement on the industry interpretation of the standard, we are seeking to designate as many contracts as possible as own use, enabling us to continue to use accrual accounting and thus minimising any marking to market on our long-term contracts. Not surprisingly, given the uncertainty and complexity, we are opting out of adopting IAS39 when restating 2004, as permitted.

The other important change will include the treatment of PRT as a tax, below operating margin. The fact that Humber Power and Spalding will be brought on to the balance sheet as finance leases, reflecting the economic influence we have on those plants. We will give greater detail on the impacts at the seminar on 4 May, when we publish our restated 2004 results, and on 15 September, when we present our 2005 half-year results on the full IRFS basis.

V. 2004 Highlights

1. Cash Generation

Clearly, as the new standards bring volatility to the external measures of profitability, cash generation – a key Centrica strength today – will be even more important to investors. 2004 was another strong year for cash generation in Centrica. EBITDA at £1.6 billion was up 15%. Operating cash flow was up, at £1.2 billion, despite significantly higher PRT and CT taxes paid, and despite the fact that we have made a £100 million one-off cash injection to the pension fund. This is immediately tax deductible and, under IFRS, is accretive to earnings.

Free cash flow was strong at £540 million, although it was down £200 million year-on-year. This was a combination of higher capex and acquisitions, up by over £500,000, offset by the AA cash proceeds net of the special dividend and buyback. As you know, we have maintained momentum in the buyback programme, purchasing around £60 million worth of shares so far in 2005. A further important benefit of the AA deal was the transfer of £245 million of FRS17 pension deficit to the purchasers.

Finally, our net cash balance totalled £296 million at the year end. Although clearly not the optimum balance sheet structure, this financial strength gives us the headroom we require to execute on the upstream investment plans we laid out last year.

2. Return on Capital

Given our commitment to such future investments, it is important that we maintain our financial rigour and patience, and continue our record of generating attractive returns on invested capital (ROIC). ROIC in our UK Energy business is 14%, despite deeming an extra £4 billion to invested capital to reflect the fair value of the British Gas brand and Morecambe Bay. In North America, although we are still building our presence we are already creating value, with a ROIC of over 11%. Overall, Group returns of 14% are up 175 basis points year-on-year. ROIC is a key measure of our performance and we continue to apply our customer and financial discipline as we look to invest necessary capital in our upstream business.

3. Returns to Shareholders

Another thing that marks out 2004 is that we delivered a step change in returns to shareholders. We are recommending an 8.6 pence per share ordinary dividend, equivalent to 40% of our earnings. This is a 59% year-on-year increase. Over the past five years our dividend has grown 28% compound annually. The sale of the AA enabled us to unlock the huge value we created and to reward our shareholders through the special dividend and the buyback programme. Yet again, we believe we have shown a good balance of investment for growth and increasing income for our shareholders. We will continue to generate good cash flow from our business model, both to reward shareholders through further dividend increases and to invest greater capital in value-creating opportunities.

VI. Summary

To sum up 2004: operating profit was up 16%, EPS was up 19%, ordinary dividend was up 59% and a further £1.3 billion was returned to shareholders. I think the 2004 numbers speak for themselves. With that, I will hand over to Roy.

Strategy and Outlook

Sir Roy Gardner

Chief Executive, Centrica plc

I. Review of 2004

Thank you, Phil, and good morning everyone. Let me start by reflecting briefly on 2004. As Phil highlighted, we made a significant step-change in the amount of cash flow returned to shareholders. On the strategic front, we sold the AA and we focused on energy and related services. At the time of that announcement, we set out a robust upstream strategy and our plans for investment. Since then, Jake and his team have made good progress pursuing a number of opportunities. However, faced with higher commodity prices, we – like other suppliers – had to take a tough decision on retail pricing, which subsequently led to increased customer churn. This reinforced the importance of our business transformation programme. In 2004 we made significant progress in delivering these new systems, processes and organisational changes that will improve operational efficiency and significantly reduce our cost base going forward.

II. Agenda for 2005

1. Leverage our Scale

Let us now turn to our agenda for 2005. As the largest supplier of energy in the UK, one of our key competitive advantages is scale. It enables us to aim for world-class cost to serve, it gives us strength in the market and gets us to the table in upstream negotiations. It also gives us significant cross-selling opportunity. Top of the agenda for 2005 is to leverage our scale to drive value in the business.

2. Focus on Customer Growth

In addition, we will be focusing on customer growth. No one should assume that continued erosion of our customer base is inevitable. In 2003 we grew customer numbers and I am determined to start doing so again this year. We have already started to fight back. This means that we must reduce churn and increase service by getting our sales and marketing right, and by offering compelling propositions at competitive prices, with an appropriate cost base and level of customer service. I am confident we can do this.

3. Manage for Growth

These are our immediate imperatives. Of course, we must also manage the business for longer-term value delivery. Home Services not only supports our Energy business, but is also a growth area in its own right. We have to continue to develop that potential this year. We have to continue to progress our upstream investment plans and manage for growth in our other business areas: telecoms, North America and Europe.

III. Action Plan for British Gas

1. Getting Back to Growth

Let me start with our action plan for growth in British Gas. We are making some organisational changes to strengthen the existing link between energy procurement and the customer proposition, which will increase our potential for pricing innovation whilst optimising gross margin. We are increasing our investment in sales and marketing, we have doubled our outbound telemarketing capability, and we are actively recruiting to increase our field sales force. We completed the rollout of our new cross-selling system, which gives our customer service agents better sales prompts and increases the effectiveness of this channel. We are also being more proactive in saving and winning back customers who have already left.

We are developing new propositions, some of which have already been launched. For example, to the end of last week over 630,000 customers had signed up for our new three-winter energy contract where, for a small premium, customers have the advantage of a capped price. This has proved to be an effective retention tool and we are now using it to successfully acquire new customers. We are also using our telecoms capability to offer free evening and weekend calls as a sales incentive for energy acquisition. We trialled this for electricity last year and it substantially increased conversion rates and reduced churn for both electricity and telecoms. We have just started to roll it out nationally for both gas and electricity acquisition.

We have also launched our first offer to energy customers that provides them with unique priority access to our engineers for one-off repairs. Customer feedback shows that this gives a strong incentive to stay with British Gas and it provides a further channel for selling our care contracts. All of these propositions are being supported by a much higher profile marketing campaign.

2. Results to Date

The action plan is firmly underway and early results are encouraging. This chart shows gross churn versus average weekly sales. We have now seen the start of recovery in both churn and sales. Churn is starting to slow and in some areas sales are back to the level where they were before the price increase. Field sales productivity is up 8% year-on-year and inbound sales conversion is up by 19%. We still have a long way to go. It is certainly early days to be drawing conclusions but so far, so good.

3. Operational Efficiency and Cost Base

a. New cross-selling system

Let us move on to our next imperative: improving efficiency and reducing the cost base. Our new cross-selling system not only increases our capability to sell, but it is also already bringing down the average cost to acquire. We are now user testing the new SAP billing system and we will carry out the first small migration of real customers to the system in the summer. We will start the larger-scale migrations towards the end of the year. It is absolutely critical that we implement the new system without impacting customer service. The current intention is to go for an extended migration, which means that full implementation will not be complete until the second half of 2006.

b. New engineer deployment system

In Home Services, we have now started to roll out the new engineer deployment system, which produced substantial benefits in the pilot phase involving around 150 of our engineers in South Wales. First time fix rates improved by 5%, providing improved customer services as well as higher productivity. Engineer travel times reduced by 15% as a result of better scheduling and GPS route guidance.

c. Headcount reductions

We are continuing to re-engineer our processes and improve productivity. Last year we identified around 2,000 jobs that could be removed from British Gas and support functions. 1,500 of these went in the second half of the year and the remainder will follow in 2005. We also plan to make even further headcount reductions as we move to deliver our transformation plans. We are confident of our ability to deliver the previously identified benefits in 2005. Our aim will be to minimise redundancies and protect our customer-facing capability whilst continuing to recruit more service engineers to support growth in Home Services.

I am confident that the actions we are taking will enable us to cut our cost base, improve our competitiveness and drive margin enhancement.

4. Further Growth Opportunities

Moving on to further growth opportunities, Home Services is a very important business for us. I know a number of you were at our seminar in December and heard about it in some detail then. It strongly supports our Energy business. I have already talked about how we are using it in our action plan. It increases the loyalty of our Energy customers, differentiates us from our competitors and reinforces the brand. On a standalone basis, it is a very profitable part of the Group, with 37% compound annual growth in operating profit since 1999. As we said in December, we see further growth potential in what is already a healthy operating margin. We intend to grow not only our existing products and in our existing markets, but also expand into new areas. For example, we are adapting some of our products to sell to business customers. We have already sold over 2,500 central heating contracts to this market since we launched the product late last year.

Dyno-Rod has given us access to the millions of households that rely on emergency callout and has opened up opportunities in other market sectors. Home Services is a great business and I am confident that we can draw substantially more from it going forward.

5. Upstream Investment

Turning now to the upstream of our UK Energy business, the key message that I want you to take away from this is that we have set our investment aims but we can and will remain both patient and disciplined in our approach. We have got considerable flexibility in our existing portfolio of equity and contractual positions. We have around 1.8 TCF of gas reserves and over 2.9 Gigawatts of power generation capacity, with the option to build another Gigawatt at Langage.

We have added to our contractual positions with our tolling agreement at Spalding, the coal-linked power purchase agreement with International Power, a more flexible gas supply contract with Shell, and now our 3 Bcm per year LNG contract with Petronas. You will remember that we also have 13 Bcm of gas per year contracted from Gasunie and Statoil. We are confident that new gas will come into the UK. The infrastructure is being built and gas producers are competing for market access. With our scale and our strong balance sheet, there are lots of opportunities for us.

6. Import Capacity Projects

Let us have a look at how the gas will come in. Total UK gas demand is around 105Bcm per year. There are already import projects which, by the end of 2007, will have a combined capacity of around 90Bcm: for example, the expansion of the existing interconnector IUK; BBL, the new Dutch interconnector, around 16Bcm; 20Bcm capacity at Langage, with gas coming from Ormen Lange in 2007; and LNG capacity at the Isle of Grain and Milford Haven. We do not believe this expansion of capacity has yet been fully reflected in gas and asset prices. Until it is, we will remain patient in execution of our investment plans.

I have spoken a lot this morning about our UK Energy business. Let us turn briefly to our other growth areas.

IV. Telecoms

In telecoms, One.Tel delivered a great set of results in 2004 and has now established itself as firmly profitable. Our acquisition of Telco Global enabled us to grow scale and brought us voice over internet capability. In 2005 we are moving to a new telecoms model. One.Tel will become the single platform for all of our telecoms activity. This will streamline our business and remove any duplicated areas. This model will position One.Tel even more strongly for future growth in a highly competitive market.

V. Strategy for North America

In July I outlined our strategy for continued growth in North America: organic growth in existing markets, cross-selling energy and services, building scale in business markets, and underpinning the business with upstream assets. Last year we made good progress in each of these areas. For example, since our market entry in Texas we have gained organically over 200,000 customers. In the final quarter of 2004, our organic growth more than offset our incumbent losses. We saw real growth in the Texas customer base.

In Home Services, we are now seeing strong product sales through our call centres. In October we acquired Residential Services Group to strengthen our ability to cross-sell between Energy and Home Services outside Canada. In Business Markets, we increased turnover by 62% last year. We are now offering business customers a full end-to-end product, with energy, energy management, maintenance and repair services, which gives us a very strong proposition and potential for future growth. Upstream, we added to our gas reserves in Alberta and we now have just over a gigawatt of generation capacity in Texas.

As in the UK, customer retention and growth are priorities in 2005. We are carrying out win-back activity in our incumbent areas of Texas, increasing our sales and marketing efforts in our organic areas, and continuing to look at other opportunities for profitable market entry. We are continually improving our operational efficiency, rationalising some of our back office activities and ensuring we have the most cost-effective model for our customer service activity. We have created strong foundations, have good momentum, and expect 2005 to be another year of growth. Of course, we plan to hold a seminar on North America later in the year to tell you more.

VI. Strategy for Europe

Turning finally to Continental Europe, Luminus in Belgium and Luseo in Spain are small but growing businesses. Luminus is turning over £500 million a year and has been profitable for the past two years. Luseo now has over 400 gigawatt hours of connected load. Even though it is growing rapidly, it is now running at breakeven. Looking to further expansion, we understand that Europe is not going to deregulate in the same way that the UK did and that conditions for competition will be different. We welcomed the news yesterday that the European Commission will investigate the slow progress by some countries in liberalising their energy markets. We expect this to create more certainty around market opening.

Our preferred entry strategy to the European market remains through partnerships or alliances. You will have seen our announcement on Tuesday that in partnership with Gaz de France we are in exclusive negotiations with SPE, the number two electricity generator in Belgium. I really cannot say anything more about that today.

VII. Summary and Outlook

In summary, let me recap our key priorities for this year. We will be leveraging the scale of British Gas. We are aiming to get back to customer growth in Energy. We will seek to optimise our gross margins in the face of continued uncertainty over wholesale prices, particularly in the fourth quarter. We will reduce our cost base and continue our growth pattern in Home Services. We will keep evaluating opportunities to acquire upstream assets or appropriate contractual positions. We will focus on profitable growth in other business areas.

I know there is a lot for us to do and we have a lot to deliver in 2005. Building on 2004, we have started the year with good momentum and we are determined that 2005 will be another year of strong performance, growth and shareholder reward. Thank you very much.

Questions and Answers

Jason Goddard, CSFB

Thanks for the slides around the customer churn, which you see potentially slowing down at the moment. Are you able to translate that into what it means in terms of net weekly customer changes over the last couple of months? Also, on the CRM system, what are your specific concerns in terms of delivery to customers? What has happened recently that led to the extended rollout period?

Sir Roy Gardner, Chief Executive

In terms of customer numbers, we are just six weeks into this new year but we can already see a reduction in the weekly loss rate of customers. As I said, we have a lot of actions in place. We know that in many areas our customer acquisition rates are now up to the levels we were achieving prior to the price increases. Everything is going well. The last couple of weeks have shown quite a reduction in net weekly losses. We do have some visibility going forward and we are determined to start growing the customer base again.

Mark Clare, MD British Gas

With regard to CRM systems, as Roy has alluded to, 2004 was a very strong year for us. At this time last year we announced a revised programme, following the delivery of releases that were clearly not up to standard. The key point is we have stuck to that programme. In 2004 we delivered Release 2. It is in, people are using it, and we are actually starting to see the benefit. That is very positive. Release 3, which is the core billing system, is in an advanced stage of testing. Our confidence levels are increasing daily that we will be able to hold the programme there as well. In terms of how to roll out the world's largest billing system, it must clearly be done with care. We could rush this in and cause ourselves some real problems over the winter period, so what we are doing is trying to balance getting it in as fast as we can, so we capture the benefits, with making sure we can continue to support our customers and our employees. We are developing a plan that will enable us to get that balance right: we get the benefits but we do not add risk to the business in a critical period of transformation.

Ian Mitchell, JP Morgan

I have a couple of questions. The first is on Morecambe Bay, looking at the production profile for 2005 and 2006. A couple of years ago, you were talking about a decline of 10% per annum from 2003. It seemed that 2006 levels would be a bit lower under this new profile than would have been applied then. Could you reconcile the two? Secondly, looking at customer numbers, you are clearly aiming to grow customers again throughout this year, but are you targeting to be net customer gain positive throughout the whole of 2005, or just to reduce the losses and be gaining again perhaps in the second half?

Sir Roy Gardner

I would clearly like to be net positive for the year but we will have to wait and see. I am determined to start growing the customer base as fast as we can. Every week we are taking on 30 new permanent salesmen, knocking on customers' doors. As we know from the past, this is the best way of acquiring customers. We have actually seen a significant increase in productivity. I will just drive for growing the customer base again and we will see how far we get.

Jake Ulrich, MD Centrica Energy

On Morecambe, a few years ago we said it would be a 10-15% decline going forward. If we look at it volumetrically, where we would have been under that decline rate and where we stand now with it basically going flat for the last three years, and then the drop over the next two years, it is not a significant change.

Andrew Mead, Goldman Sachs

On page five you showed the change in costs in the gas supply business as an £80 million increase. I think you mentioned that it was partly caused by increased debt provisioning costs for your customer base. Could you say how much that was and how much of a change there will be in 2005? Secondly, with regard to what you said about winning customers back, will there be an additional cost charge in going for that growth?

Sir Roy Gardner

The simple answer to the second part is: no, there will not be an additional cost other than the normal acquisition cost for customers.

Phil Bentley, Group Finance Director

There are two industry issues. One is around electricity pre-payment, where a customer has an old machine with an old card and we win the customer but they end up paying the old supplier for a time. We are currently trying to put in new EDI systems across the industry to allow for the plusses and minuses to be settled on a more regular basis. The other issue is gas in balance, where Transco effectively deems consumption below a certain level of consumption to the supply industry. We believe there are some improvements to be made in the way they do that deeming. Those are the two areas.

Just picking up on your question about these new products, if you look at the capped product, for example, the margin is as good as a normal gas sale because you have a slight premium on there. We talked about improving telesales activities, which are all commission-based activities, so they only get paid if they deliver the growth. I would not be factoring in any big cost increase. We are certainly not signalling that. In fact, we are very much on track for the 2005 total transformation savings that we have been indicating for some time.

Andrew Wright, UBS

I have two questions. One is on the weighted average cost of gas (WACOG) going forward. My understanding is that your long-term contracts and the Morecambe cross-charging include an element of lag. Are we yet to see the worst of the increases in gas costs coming through under those contractual terms? If so, could you give us some sort of guidance as to how those known elements of WACOG change? That is the main question.

Jake Ulrich

Yes, there will be a little bit of catch-up on that. Obviously we will be buying a bit more indexed gas. If month-ahead indexes for 2005 are up around 22-23% versus 2004, then I would expect the WACOG to increase slightly more than that.

Phil Bentley

There is one other point about the index. One of the reasons we benefited towards the end of 2004 and we have inherited a good position going into 2005 is when we saw, for example, in October last year January prices were at 80 pence a therm. Actually, January and systems average out-turned at 29 pence, so there was a lot of opportunity for someone like us who believed fundamentally that the market was over-bought. We have been quite flexible with our hedging strategy and will continue to be.

Richard Alderman, Merrill Lynch

Could you actually give us the average weekly loss rate so far in 2005? You say it has come down; what has it been over the past four weeks on average?

I also have a few questions on costs, just to get a better feel for the operational reengineering process data points you gave us. Firstly, what do you anticipate spending on advertising this year versus 2004? Is there any meaningful increase in that cost? Secondly, on the headcount figure of 2,000, could you explain how your temporary headcount number is changing? At the end of 2003, I think you had something like 6,000 temps. Is that number too high? Have temps gone up in replacement for full-time staff coming out? Lastly, when you first launched the CRM process you talked about a cost saving coming out of CRM of around £100-150 million. Could you say how that process is working through 2005? Do you envisage any of that falling into 2005 or will it mostly fall into 2006?

Sir Roy Gardner

On your last point, we said that about £100 million of benefit would come through in 2005 and we are confident that it will come through. The substantial benefits start to flow through in 2006 and beyond.

On customer losses, a weekly average over a four-week period does not give you too much from which to draw a conclusion, particularly at this time of year, because most of those customer changes will be in respect of what happened in November and December. I can tell you that in the last couple of weeks it was fairly low: less than 10,000.

Mark Clare

On temporary staff, it is both temporary and contract staff. We use third party providers as well. I would guess there are about 4,500 and that number is dropping rapidly. Part of the strategy of having that number of support staff who are not permanent is that as the transformation is delivered we can run those numbers down. The intent is to run that down fairly hard over the next two years. The number of temporary staff reduced in the back half of last year. It certainly did not increase.

On advertising, the total money we are spending in 2005 will be about the same as we spent in 2004 but we are getting more for it. We are driving up productivity all the time. We spoke earlier about acquisition costs. One of the things we are doing is putting an enormous amount of focus on getting some great propositions out to customers. The better the proposition, the higher the conversion rate and the higher the productivity. That is what we are seeing coming through. We are really driving the new delivery, which is enabling us to minimise any additional costs of sales or marketing. The products are pretty much selling themselves.

Phil Bentley

Just to add to that point, now that we have the new selling system which has been in place since the end of last year, on core inbound calls the sales to call ratio is up 19% year-on-year. That was part of the idea: we would get calls coming in and we would cross-sell products. We are also seeing far fewer complaints. Complaints are down by around 56% year-on-year because we are targeting the right products at the right customers. It is early days, as Roy said, but I think we are pretty pleased with the progress to date.

Bobby Chada, Morgan Stanley

Could you go into more detail about the reinvestment programme? You said that Jake and his team had been making some good progress, but we have not heard anything since July on the upstream gas side. Can you flesh that out slightly please?

Sir Roy Gardner

Yes, bearing in mind that we are only six months into a five-year programme. You should not expect too much to happen overnight. We invested about £250 million in upstream assets last year.

Jake Ulrich

It was about £400 million but if you just go into the UK it was about £250 million, which is still substantially less than we intend to spend. If you follow the recent developments, there is not a lot of upstream gas opportunity in the UKCS or Norwegian sectors. I suppose if we had won any of those deals we would be having a different conversation. I think the market is pretty frothy right now. It is pretty hot and we do not see value in any of the things we have looked at, certainly not at the auction prices. The team and I have spent quite a bit of time this year and, without going into specific details, it is obviously beyond UKCS and outside of Norway. You can think further east and further north and south. We have found a couple of opportunities. Again, I think you have to look at this on a very long-term basis. We have to add a bit more risk to the profile. We are not going to spend this money by going into auctions for developed properties. On the gas side, I hope to have a bit more to report later in the year, but I am not displeased with the progress.

On power, it is a slightly different game. As you are well aware, we have the potential at Langage for a Gigawatt. Contrary to reports, we have not decided to build that – no matter how beautiful it may be. We recently announced a coal tolling agreement and we potentially have a few more of those coming down the road. There are quite a few financial institutions and players in that sector who are interested in doing things. We might scale back the potential investment on the coal side if we can do a few more of these types of deals.

Bobby Chada

Are the froth and auction prices for UKCS assets reflected in discussions about buying into LNG projects in the Middle East as well, or is the pricing dynamic there different?

Jake Ulrich

I think there is a slight disconnect. Getting into upstream projects, the recent one in Algeria was a fairly rich price, but there are areas of the world where that premium is not as high.

Martin Brough, Dresdner Kleinwort Wasserstein

Can I follow up on the investments you have already made in UK power stations? Are they actually giving you any hedge on your procurement so far? In other words, are they actually making a positive margin? Also, in terms of Spalding, given that you have said that the power prices are not really at [new entrant costs?] and it is a tolling contract, which presumably covers the entire cost of the new build, do you expect that to be a profitable contract?

Jake Ulrich

On Spalding, yes we do. On the other power plants, given where the spread is at the moment, it is slightly positive but it is not that great. I do not know how else to put that. The gas prices have certainly impinged on profitability. I think if we see a return to prices that we think are more representative of the true supply/demand balance, then it will be fairly profitable. The other issue is that it is fairly hard to judge exactly how profitable these are, because we would be going out to the peak market to cover that, if we did not have these plants, so we have to assume a price for that. Generally, we expect it to be slightly better than neutral.

Richard Gray, UBS

I have two very quick questions. Firstly, on the capped price, you talked about there being a customer retention product. Does that mean the 600,000 customers you have taken are entirely internal switches? Secondly, you talked about having a slightly more innovative approach to hedging and about the fact there was backwardation in the first quarter of this year. In the first quarter of 2006, where margin again looks to be pretty tight in the UK, prices have spiked up in the last week or so, on various metrics: oil price, temperature, etc. Does that mean that you might consider selling forward Morecambe production now and perhaps increasing your risk profile, just taking a bet on backwardation taking place next first quarter?

Mark Clare

In terms of the capped product, remember that we already have a capped product for electricity. Historically, we have signed up a large number of customers, about 800,000 customers, who take capped electricity. What we have done now is to introduce a dual fuel cap or a cap on gas, which is unique. Nobody else offers a cap on gas. We have sold 630,000 of these. The bulk of those are sold to existing customers. We focus on high-value customers and target them directly, looking for retention benefit. The retention benefit is very substantial when these customers take up these products. Last year, for the first time, we started to sell this through our sales channel as well, specifically on our save channels. Where customers are saying, ‘I am thinking of leaving you,’ we can say, ‘We have this great offer.’ We are now using it as a positive sales aid. The problem is that it is a bit complex. There is a slight premium and an exit cost, and it is obviously a more complex product for customers, but everybody knows about fixed-priced mortgages. This is a capped product which is better than that. It is starting to move through our sales channels as well. It is another useful proposition to ensure that we fight back as hard as we can.

Phil Bentley

I have a couple of points to make. We get a couple of cold days in February and suddenly winter 2006 shoots up. You really have to look at what liquidity is actually being traded in the market. Our view is that the volume of liquidity, at that length, is just not there. Whatever price is on the screen is not a price that people can deal at. Clearly it is not for us to reveal commercial sensitivities around how we hedge and what positions we have on a daily basis, but the net position I think we would have is that winter 2005, spring 2006 is probably overdone, in our view.

Jake Ulrich

I was just going to mention the liquidity issues. As you look year-on-year, from 2002 it dropped 20% for 2003; this year liquidity is another 20% lower. It is very difficult to place any types of trades in any kind of volume, as Phil explained. That is the primary point.

Richard Gray

Is it true that you will use hedging not just to cover downside risk but potentially to capture upside risk as well?

Jake Ulrich

We put out some guidelines at the end of 2003 about what kind of hedging ranges we had. We have not changed that policy but we do change the area in there. If we think prices are fairly high – again, we think 51 pence for Q106 is pretty warm – we would not hedge as much. We certainly would not be buying a lot of 51 pence gas.

Richard Alderman, Merrill Lynch

Whilst obviously not asking you for a profit forecast, I am just trying to get my mind around the various moving parts of your business this year. Given the rise in your average operating costs from the customer losses really feeding into this year's numbers, netted off against the customer gains that you anticipate and your increasing WACOG and electricity costs, do you see any meaningful change in your underlying residential margin this year? Or should we expect it to be in roughly the same area as in 2004?

Sir Roy Gardner

We have given guidance on this before. We said that the margin in British Gas overall would be roughly the same as it is in 2004. That is still the position.

Andrew Mead, Goldman Sachs

Is there any theoretical tension on the Board between your patience and disciplined approach to investment and potentially increasing financial headroom through the year? A year ago, you talked about maintaining balance sheet efficiency going forward.

Roger Carr, Chairman

I can give you the Chairman's perspective. We have been very clear that the issue of using shareholder funds wisely is absolutely the focus of the Board's commitment. In very frothy markets where there are very high prices for assets, unless we can create value for a particular set of reasons then we are unlikely to buy. We feel no pressure to do so, because to overreact in pursuit of some sort of acquisition target horizon, at the expense of shareholder funds and value creation, would be the wrong decision. There is no sense of pressure either from management or from the Board. What we have tried to do is to give everybody a fairly clear insight into our ambition and a reasonable timescale to fulfil that. Given the volatility in the market, then the conditions in 2006 may be completely different from those in 2005. That is the fundamental of our thinking: no pressure. We accept that for a period, because of that, the balance sheet may appear to be inefficient.

The judgement call, somewhere along the line, is whether the wealth of value we have created by running the business has piled up to the point that keeping it is at the expense of shareholders. That is still some way off and we have been clear with shareholders that our ability to be patient is very important and our discipline is critical, but our ability to act from a good balance sheet position is absolutely fundamental to getting a good deal when it is available. That is what we have done in the past. That is the balance we will keep. You should keep that in your mind in assessing the way the business is going. These things are not forever. We have no sense of hoarding cash for a rainy day; we will keep cash to use it wisely to make acquisitions when value can be created.

Bobby Chada, Morgan Stanley

I just have two follow-up questions. Firstly, on the telecom business, to make sure I understand it, you said you were using One.Tel as the only platform. Does that mean you will stop using the British Gas Communications brand? The second question is on the margin for 2005 versus 2004. Are you referring to a percentage margin or an absolute figure in millions of pounds?

Sir Roy Gardner

It is a percentage margin. On telecoms, yes, we are only going to market using the One.Tel brand. It will be One.Tel from British Gas. We will do that for both residential and business customers.

Roger Carr

That wraps up the questions. Thank you all very much for coming.

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