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Interim management statement 12 May 2008

Conference call transcript

Sam Laidlaw - Chief Executive

Well good morning everybody. I'm Sam Laidlaw, Chief Executive Officer of Centrica, and I'm joined here by Nick Luff, Group Finance Director. Thank you very much for taking the time to join us this morning. As you will have seen we released our Interim Management Statement at 7:00 am ahead of our AGM later this afternoon. What I would like to do is just spend a few minutes taking you through the key messages in this morning's statement and then invite your questions, which Nick and I will be happy to answer.

2008 so far has clearly been dominated by extremely high wholesale gas and power prices, not only year to date, but also the forward prices for next winter. Now this is really influenced by clearly record oil prices; on Friday we saw oil prices above $126 a barrel, but also of course on the LNG side strong demand for LNG in Asia, and limited pipeline imports of gas from Norway and Europe. All these factors really have meant that for the first four months of the year, gas and power prices were trading 92% and 100% respectively above their 2007 levels. Gas prices continue to rise since our tariff increase in January, with the fourth quarter of this year up over 30%. British Gas margins in the first half of this year will certainly still be positive, but they will be below the 6 to 7% long run expectation.

But customer service is continuing to improve. Energywatch complaints are now down almost 80% since the 2007 levels, and we are consistently answering calls, on average our ASAs are running 60% faster. However sales of energy accounts have slowed a little since January and we have 15.9 million accounts on supply at the end of April. High wholesale prices, have on the other side of the equation been very positive for the gas production business, both in terms of volumes and in terms of selling prices, and therefore profit for the gas production business will be well ahead of 2007. Morecambe, the North Sea asset base and the recent acquisitions have all made an important contribution to this. Partially off-setting this, we've seen a material increase in the I&C contracts. Input costs have risen, clearly, and also customers have nominated to take more gas.

Looking across the rest of the group, BGB has continued to grow. BGB's results are less impacted in the period by the wholesale price increases, due to the structure of their contract book. We've also seen continued very good operational performance at BGS, the services business, and that's underpinned further growth and a strong financial result. We're pleased with the strategic progress in North America, and the Rockyview and TransGlobe deals, and the recent acquisition of Strategic Energy in the I&C space are all very positive for this business. The downturn clearly is starting to be felt across North America, and the financial performance may be a little bit weaker in the services business, but we are back growing our customer base. In Centrica Storage, it's been a very strong operational performance. Profits are lower to date as forecast on the lower 07/08 last winter's SBU price. We've completed the sale for the 08/09 SBU volume at 38.82p. The group interest charge does continue to benefit from an accounting credit from the pension scheme and just for reference in the full year last year 2007; this amounted to £55 million.

So now to the outlook. The first half of 2007 was as you'll recall an exceptional period, which we don't expect to repeat this year. First half 2008 will be materially lower due primarily to the exceptional result of BGR last year. As mentioned earlier, the gas price for the winter is very high, and would be the highest winter ever by some way if the current forward price out turned. Q4 has now been high for quite a while and is still over 80p a therm. Last year Q4 was 44p. This is a very material benefit to the gas production business. On the current curve, upside here would more than off-set the extreme year-on-year movement in the I&C contracts. But the shift in profits mixed to the upstream from the downstream means earnings is negatively impacted on an after-tax basis as a result of the increase in the group tax rate. Currently forecast, the effective tax rate for this year at 55%

compared to last year at 40%. Looking forward from here, further retail pricing across the industry, a further retail price increase really across the industry looks inevitable, unless of course there is a large and sustained downward movement in the winter curve. We are clear that we will take the necessary action to deliver a reasonable margin in British Gas in 2008, and Nick and I are focussed on delivering that. So I think with that, I will ask the operator to open up lines for questions.

Questions and Answers

Jamie Tunnicliffe ABN Amro:

Good morning. Just, I&C is always a very difficult business on the outside to have a very clear view on. I think you guided and you said obviously the losses there you expect to be tougher than previous expectations. Are we talking sort of a couple of hundred million higher than sort of what you were saying, maybe at the end of last year or can you give us some sort of help there, because it is a…

Sam Laidlaw:

You're right, it is a hard thing to model because not just the price effect but also the take that customers nominate, it is hard to model.

Nick Luff:

But in broad terms Jamie, we're clearly saying gas production up a lot, I&C down a lot and you're talking gas production up perhaps £500 million compared to consensus and I&C down £200 million compared to consensus, obviously there is a knock-on effect on the tax charge. But net net they are obviously, on an operating level, the net of the two is very positive.

Sam Laidlaw:

Operating profit will be strong.

Nick Luff:

And just to put some other numbers… the I&C margin has deteriorated by sort of about 25p a therm compared to last year. You know, that's a sort of 30p increase in the input price and it's, yes a small off-set from the selling price. So the net declined to 25p, multiply that by 2.2 billion therms and that gets you the year-on-year swing.

Luis Amusategui Cygnus AM:

Good morning everyone. I just want to have a better feeling on how much do you think the increased gas prices would make you increase your retail prices, in order to maintain this level of profitability that you just talked about. Are you talking about obtaining something in the region of 3% or would you be happy with just 1% this year, what kind of level would you prefer to be depending on how oil prices, or meaning gas prices are in the UK?

Sam Laidlaw:

Luis I think you will appreciate that we are not able to give any forward looking information about price increases that we may or may not make, or price reductions for that matter. Clearly this is a very competitive market, and we intend to keep it that way. We have an Ofgem investigation under way, and certainly as and when we make a decision to increase prices or in any situation reduce prices then we'll notify everybody and all our customers at the same time.

Peter Bisztyga Citigroup:

Hi, it's Peter Bisztyga speaking here from Citigroup. Bearing in mind you've just said that you don't give any forward looking statement, but in the past in some of your trading statements you've made a comment about consensus earnings expectations. Could you tell us roughly where you think consensus is at the moment on EPS and whether you think that's realistic given what you've said in your statement today?

Nick Luff:

Yes, Peter on a pre-tax level, let me start at that, pre-tax level consensus is about £1.7 billion of pre-tax profit, and we're clearly signalling we expect that to go up because of this increase in gas production profit more than off-setting the decline in the I&C contracts. But then factor in the tax charge increase, then consensus is about 26p, I think if people, if you look at the more recent numbers they're a bit lower than that and if you catch up with the tax charge it may come down a bit.

Jamie Tunnicliffe ABN Amro:
I just wondered also, on the cost-cutting front here, clearly we have seen some, pretty predictable I suppose pressures on your business given how things are being moved, but you know are there things that you can do to accelerate on the cost-reduction side?

Sam Laidlaw:
It's a good question Jamie, we're keeping our foot to the floor here. We have, I think got, a sufficiently well-grounded, robust programme that although we are facing a lot of inflationary pressures we are able to stick with the existing targets and deliver against those. We're also looking, obviously starting the process of looking forward into sort of late 2008/2009 and you know we expect continuously to take further costs out of the business, but despite the inflationary pressures that we see across the board, we had a review only last week and we're still on track, so I think we're managing to combat those pressures.

Jamie Tunnicliffe ABN Amro:
And is there anything you can say on, clearly I suppose you are always aware of the sort of working capital sort of movements here with commodity, sort of outlook there?

Nick Luff:
Honestly Jamie, in terms of what the sort of year-end position will look like, will very much depend on you know whether there is a retail tariff increase, the timing of it, because obviously the later in the year you do it the longer it takes to feed through into direct debits adjustments and things, but we had a very big inflow last year of working capital, you know a couple of hundred million, and that will almost certainly reverse this year, but you know we're managing it, I think it's inevitable with higher gas prices we get more working capital, but it's manageable.

Nicholas Ashworth Morgan Stanley:
Morning guys. I just have a quick question on customer numbers and churn and just if you can give some colour as to what you're seeing in the industry over the last few months?

Sam Laidlaw:
I think clearly the fact that prices are going up again and have been going up in the first quarter means that perhaps churn has picked up a little bit, but in terms of our own customer sales and notifications, I think certainly we felt that the price increase that we had in January, the 15% price increase, was certainly much better handled and operationalised and therefore we didn't see the losses that we've seen with prior increases. We had a little bit of an uptick later on but actually we're starting to see it stabilise and we're starting to see our sales improve week on week and that's important for us. But I think, looking forward we think that where we are currently priced is a good place to be, certainly on our dual fuel offering and on our gas offering we're very competitive, and we, I think signalled very clearly at the full year results in February that actually as a result of segmenting this business into three, we are not just managing customer numbers now, we're very much managing for value, so if we do lose a few customers that are loss-making, that won't be the end of the world; what we are focussed on is delivering the best value from this business and with SAP now up and running we're actually getting much better customer MI than we've ever had before and we really understand where the valuable customers are and that's important.

Chris Rowland Ecofin:
Hi, morning I suspect you probably won't want to answer any of these questions, but I thought that I would ask them anyhow. One on the tariff side; I heard the description that a tariff increase is inevitable and if that is the case then…?

Sam Laidlaw:
I said it looks inevitable unless there is a large and sustained downward movement in the winter curve.

Chris Rowland Ecofin:
I don't suppose that you would like to say how long you will wait to hear that or is just something that we will just need to see?

Sam Laidlaw:
I think you're opening observation was absolutely correct.

Chris Rowland Ecofin:
Let me ask you two other things; just if you have got any update on what is going on with British Energy and if you've got any update on what is going on with Accenture?

Sam Laidlaw:
I mean we read what you read about British Energy, we obviously follow it closely, but it is a public company and under the panel rules there is nothing that we can say there. In terms of Accenture, it is clearly now very much in the press, we were not happy with clearly the service level that the SAP system offered, in our view are very clear fundamental design defects in the system; now the good news is that we have now rectified those defects and the system is working. But last year as a result of those fundamental defects, we as you know had to firstly take a sizeable financial charge on our capital investment and we also had to add a significant number of agents in our call centres to deal with the literally millions of exceptions that the system was spewing out, and that caused us considerable additional operating costs, impact to earnings and brand damage and poor reputation for customer service. Now, we got on top of that, but we have brought in independent consultants, we attempted to mediate with Accenture with no success and therefore we are going to pursue our remedies through the courts, but I think that is well documented.

Chris Rowland Ecofin:
And if I can just follow on, the action that you are pursuing through the courts, is that essentially for the incremental cost or is also for the business damage?

Nick Luff:
It is a legal process Chris, you would not expect us to comment or give any detail on it.

Edmund Reid Cazenove:
Hi. I have three questions; the first one was just on consensus you might not have this to hand, but do you know what margin people are assuming or the average margin for British Gas Residential within that consensus number in the UK; and then the second question, given the current commodity price environment how easy do you think it will be to execute your upstream hedging strategy in the short term, and do you think there would be any value in waiting until….?

Nick Luff:
Do you mean on the structural hedge?

Edmund Reid Cazenove:
Precisely, exactly; do you think there would be any value in waiting until maybe the pricing environment moderates somewhat?

Nick Luff:
I will let Sam answer that one. On the first one Ed, people's numbers for residential are in the £350m to £400m range. It depends partly on your revenue assumption, but that works out at around 4 to 5% margin depending on

your revenue assumption. The more recent forecasts have probably been towards the lower end of that range and the more up to date ones, are at the higher end. That is where they are at. I will let Sam answer the…

Sam Laidlaw:
I think that your second question, given the big run up we've have had in commodity prices across the board, should we wait until they pause for breathe. I mean I think that the question is very asset specific in that if we can buy long life LNG assets it is all a question of how they price all long life gas fields or contract gas, at the end of the day the question is are we seeing a price differential gas versus oil that is attractive; and if we continue to see value there then we will still pursue the opportunities. So I think the answer to your question is, no we are not going to pause in this endeavour because we fundamentally believe that yes there may have been a very strong performance from commodities in the last few months, but actually long term we can see this trend continuing whether it is oil, whether it gas, whether it is coal, whether it is carbon, we can see continued upward pressure absent a significant global recession. Therefore I think we need to continue to invest, but we are only investing for value Ed and a number of shareholders have said to us, well actually if you do this, you will take so much risk out of the business, you will reduce your WACC and therefore increase your multiple and you should actually stretch to do things below our current WACC we are not going to do that we are remaining disciplined about this, we will only invest for value opportunities; and the acquisitions that we did with Newfield, that we did recently in North America at both Rockyview and TransGlobe are all basically good double digit returns in this environment and obviously if we then have further increases in gas price that helps, and we expect to see gas prices and oil price converge, so I would be more optimistic if you want to put it that way about gas prices than I would about oil prices at the moment.

Ian Mitchell JPMorgan:
Hi just a quick question about gas supplies, you mentioned high LNG demands, you mentioned Norwegian gas supplies and gas supplies on the Continent were fairly low; could you just talk a little bit about what you think the background drivers are particularly on Norway, do you think there is supply issues there which could be resolved or do you think is a deliberate trading strategy of the Norwegians, in which case we are unlikely to see much in the way of moderation in the short term?

Sam Laidlaw:
It is a good question, my guess is there are three factors in Norway, the first has been technical constraints which I would characterise as being more short term than long term in, that I think are still due to complete a number of wells at Ormen Lange and bring back some fields on stream and once those fields come back, hopefully volumes will increase. The second element is commercial, in that clearly they have European contracts that have buyers nomination to take different quantities and European buyers have been drawing down at high rates on those contracts and the third piece is the weakness of Sterling relative to the Euro, means that clearly the Norwegians would rather sell into the European market unless they can get a Sterling price that compensates for the weakness of Sterling.

Ian Mitchell JPMorgan:
So broadly unless we get a strengthening in Sterling then there is not much in the way of positive news likely to come out of Norwegian gas supplies, therefore a bit you think?

Sam Laidlaw:
I think the technical piece in terms of technical deliverability hopefully will increase, I know that Norwegian producers are working very hard to try and maximise their output and increase their gas output. So, hopefully we will see a bigger cake, or what slice of the cake we get will be determined by the contractual arrangements in Europe and the price of Sterling.

Angelos Anastasiou Pali:
Good morning. I was just going to ask on the gas production side, just to try and get a little bit more clarification;

have you had any further thoughts on volumes that you could add on that side and I think you mentioned that you suggested profitability wise over £500 million more than consensus was the likely figure that we are heading towards and just what consensus was as a starting base on that - thank you.

Nick Luff:
Consensus is just under £700 million of operating profit compared to £429m we made last year. We produced about 2 billion therms last year; we expect to be about 10% ahead of that this year on current production numbers.

Jamie Tunnicliffe ABN Amro:
Just was interested in what you said about carrying on with the efforts to improve the physical hedge, and you expect to see gas prices and oil prices continue to converge, but then why do use a phrase saying forward gas prices remain stubbornly high?

Sam Laidlaw:
Well I think we recognise that passing those price increases on to customers is going to be painful for our customers.

Sam Laidlaw:
Well thank you all very much for joining the call, some of you we may see at our AGM this afternoon, but thank you all very much for your interest.

Nick Luff:
Thanks everybody.