Centrica Interim Results 2007

2 August 2007
Presentation Transcript

Roger Carr - Chairman

Well good morning ladies and gentleman and welcome to those that aren't on holiday this week. As normal we've got Sam Laidlaw and Nick Luff at the front. We have also got some other members of the Executive team in the front row, Jake Ulrich, Chris Weston, Grant Dawson, Catherine May and of course the now acceptable face of British Gas and consumerism, Phil Bentley, who is rather more used to being on this side of the table. I am also very pleased to say that we have got with us this morning Mary Francis who I know some of you have met, our Senior Non-Executive Director.

Financial performance of the Company in the first half has been good with strong growth in operating profits, earnings and cash flows. The achievements are in part attributable to the considerable efforts of management who have continued to drive sales while addressing costs to improve profit performance in our businesses both at home and abroad. Nick and Sam will provide greater detail on the results in a moment but there are a couple of points I would like to make at this stage.

Firstly, I would emphasise that the high point achieved in the British Gas profit and margins is due to the inevitable time taken for our two price reductions in retail prices to catch up with what turned out to be a rapid fall in wholesale prices. Secondly, the favourable profit mix affect from the increased weighting towards the retail profits attracted a lower Group tax charge as upstream profits are taxed much more heavily than their downstream equivalent. It is unlikely that this position will be repeated in the second half when the more traditional mix of upstream and downstream profits are currently forecast to be restored. Clearly when viewed over a longer period these residential supply profits serve to offset the losses incurred in the comparable period in 2006 when wholesale costs escalated to unprecedented levels well ahead of retail price increases. Looking to the future the impact of price reductions already made and forward projections of wholesale energy costs suggest second half margins will be more in keeping with our stated aim of delivering more sustainable profit levels.

These results therefore should be viewed in the context of the exceptional conditions which prevailed in the first six months. Equally the challenges that faced the company in terms of remaining competitive, delivering superior customer service, reducing costs and improving the hedge by acquiring gas assets must remain in sharp focus. In this context I am very pleased with the performance of the newly formed Executive Team under Sam's leadership with Nick Luff bringing fresh insights and increased rigour to our financial disciplines and Phil Bentley combining his energy and detailed grasp of the business to reinvigorate and strengthen the British Gas operation.

The benefits of competitive pricing and innovating marketing are now starting to be reflected in reduced customer churn and improving customer numbers and the team remain heavily focused on the delivery of high quality customer service. To that end we have prioritised improving customer service over short term cost reduction and the additional one off investment in people necessary to effect this improvement will be reflected in a delay in us delivering the full £200 million of cost saving. The balance will be delivered in 2008.

The Board believe that the early provision of excellent customer service is fundamental to the long term health of the business and will ultimately result in us achieving the position of the provider with the lowest cost to serve.

Finally, upstream assets at value creative price levels have remained elusive, but the strong cash flows of the business will enable us to take immediate advantage of any opportunities should they arise. I would emphasise however that whilst the Board consider the acquisition of gas and power assets and further reinvestment in our growth businesses to be the priorities, we will continue to monitor the Balance Sheet and would also consider further returns of surplus funds to shareholders if and when appropriate.

I will now hand over to Nick to review the financial results in more detail. Nick.

Nick Luff - Group Finance Director

Thank you Roger. Good morning everyone. And obviously a very good first half for Centrica. I am not sure how much credit I can take for the results personally, but here goes.

I will start by giving you some Group numbers and then go in a bit more detail into the business units. So starting at the top, the Group revenue actually slightly, down which was due to the reduced consumption in British Gas residential which I will come back to later. But that reduction in revenue more than offset by the significant reduction in commodity costs and as a result operating profit up substantially up 80% to £1 ¼ billion. Within that, a significant change of mix as Roger was talking about from the upstream which of course is quite highly taxed to the more normally taxed downstream businesses. As a result of that the tax charge, as you see, down from the high level of 51% in the first half last time to just 34% this time. The combination of that low tax rate on that higher operating profit and indeed a reduced interest charge as well gave us very strong earnings growth close to £800 million of earnings which translates into 21 ½ pence per share. The interim dividend as is our normal practice, we set at 30% of last year's full year dividend which works out at 3.35 pence.

Obviously the key feature in these results has been the movements in Gas Wholesale prices and how retail prices have reacted to that. This chart just shows how the prices have moved over the last couple of years. Wholesale prices moving quite fast of course and quite volatile and in a volatile way, shown in blue, retail prices shown in orange. And of course as you know our margins do tend to get squeezed on the way up as wholesale prices rise, as wholesale prices come down that is our opportunity to restore margins. And in comparing this first half results to the first half of 2006 you are in a sense going from one extreme to the other as far as that dynamic is concerned and hence the dramatic turnaround of results that you see today.

So going into the individual business units you can immediately see the significant shift from the upstream to the downstream. That is starting at the top there, British Gas residential, loss first time in the first half of last year, profit of over £500 million this time around. Obviously the commodity price has been the main factor there, but let me also pick up on some other features for you. Consumption was actually down both in gas and power, mainly gas of course because of the warm weather as shown in the top two charts there. That of course fed through to lower volumes which in turn fed through to lower revenue shown in the bottom left. But that was more than offset by that commodity cost decrease and hence the dramatic turnaround in British Gas residential's profit. The other contributor to that turnaround has been the reduction in operating expenditure, BG OpEx down some £30 million in the first half. We are accelerating at cost savings as we go into the second half. But as Roger was saying, we have consciously delayed some of our cost saving initiatives so as a result we are looking to full year cost reductions of about £140 million against last year's number with the full £200 million of cost savings we are targeting coming through in 2008.

The other point of note with OpEx, if you are looking at the numbers, we have reclassified the energy efficiency commitment expenditure the EEC expenditure. It doesn't make any difference to the first half versus first half. We have moved it up into margin. This spend was about £45 million in both periods but if you are looking at the absolute numbers you just need to be careful of that particular change.

In contrast to BGR, Centrica Energy is down quite significantly and that is all about gas production profits. There were actually a couple of positives in there as well and to give you that detail. Gas production, obviously the price for which we sold the gas we produced was much reduced because of the lower wholesale prices. Also partly affected by the new transfer pricing formula, which we agreed with the Revenue, which also brought down the average selling price out of Morecambe a little bit. So the gas selling price at the top left there, down some 60%. As a consequence of that low price, it was often more economic for us to buy from the market rather than produce from Morecambe. So our actual gas production volumes were down as well some 23% shown on the top right.

A combination of lower volumes, significantly lower selling price, gas production profits down some 80%. The two offsets within CE's end result there were power generation and the legacy industrial and commercial contracts. Power generation we are now separating out as a separate segment so that you can see the contribution we are getting from the power stations. And of course all our UK power stations are gas fired. As a result of the low gas price they were much more competitive in the first half, we ran them more often, produced significantly more power. Power generation up something like 80% and a profit contribution from the power stations of £47 million as a result. And the I&C contracts on the right there, bottom right, obviously they have been loss making in the past. Again the low input price, the low commodity price meant that we could turn those back into profit. We made a profit of close to £150 million in the first half. It has to be said though that today's prices, if they were sustained we would be back in a loss position as far as the I&C contracts are concerned for the second half.

Let me touch briefly on the other businesses. BGB had a very strong first half, profits up quite significantly again helped by the low commodity price, offset by lower consumption to some degree but also helped by higher customer numbers as they continue to grow that business. Also within there we have got some historic low price electricity purchase contracts which are benefiting the results. They will benefit this year's results by about £30 million. That comes off in 2008 so these figures are improved by that. Nevertheless even if you split that out, still a very strong result from BGB.

Storage also having another good year financially. Of course these results reflect the prices we achieved for the 2006/7 storage year which ended in April. We were selling capacity for that year back in winter '05/'06 of course when gas price was a lot higher than it is today and in particular the summer/winter differential on forward prices was much higher than it is today and hence the value of storage was much higher. So you see that flowing through in these figures.

Services also had a good first half, some of the service issues we had in that business in the '05/'06 winter are now well behind us. Improved efficiency and growing customer numbers here coming through strongly, good result in the first half and well placed for some good performance for the second half as well.

North America a sterling result here, up 9%. But if you go back into the local currencies of Canadian dollars and US dollars you will find the operating profit actually up 20% so a very strong performance. Mainly due to a strong contribution from the upstream and wholesale energy segment and also quite a strong performance from the retail business out in the US, particularly in Texas. Although as we have said in the Statement, that market is becoming more competitive so those high margins we have been enjoying in Texas are likely to come down in the second half.

And finally Europe which as you know moved into profit in the second half of last year. We continue that positive trend and the businesses there on a combined basis contributing profit at £11 million in the first half this year. So overall strong operating performances with operating profit up to close to £1 ¼ billion.

And that flowed through well to cash flow as well. If I take you through the key features here. The EBITDA was up in line with the operating profit increase, with a much lower seasonal outflow of working capital, again due to the low commodity price. You see interest and tax payments coming down, a lot lower than they were last year, mainly due to lower PRT payments and the way that the lagging and the readjustment happens with the PRT payments. We had a very low cash tax on PRT in the first half and we see the benefit of that in the cash flow. Coming down a bit further. CapEx also down about £100 million, £300 million net spend in the first half. Full year guidance for that. We are looking at spending a net of about £800 million with Langage the new power station in Devon and Lynn and Inner Dowsing Wind Farm also being a significant absorber of CapEx. So full year we reckon on spending around £800 million subject of course to any significant moves we make on the upstream assets.

So you put all that together we generated cash inflow of almost £600 million which has brought the net debt down to under a billion. That obviously leaves us with significant Balance Sheet headroom which we can use to fund those upstream investments we are seeking. But as Roger was saying, we will continue to monitor the efficiency of the Balance Sheet. If we don't see those upstream investments being there in a reasonable timeframe and being there available at sensible prices then we would look at returning funds to shareholders.

In summary then, a very strong first half, dominated by the fall in the wholesale prices which have shifted profits from the upstream to the downstream. As a result of that we have been able to not only cut prices for consumers in British Gas Residential, but also to restore our profit margins. Elsewhere in the Group, all the growth businesses also performed well. We benefited from a much lower tax rate because of the change in mix of profits and all that produced a very strong earnings performance and very strong cash generation as well.

And with that I will hand you to Sam.

Chief Executive's Review
Sam Laidlaw - Chief Executive

Thank you very much, Nick. Well good morning, everyone. As Nick has told you, our first half results were strong. The wholesale gas price I think was clearly in the early part of the year was a big driver for this. But this is not just a commodity price story. I would like to just remind you of the strategic priorities that we set out for this business back in February and spend a little time considering where we are against those priorities.

Our clear goal is to deliver superior returns throughout the commodity price cycle. In order to do that we set out four priorities. To transform British Gas, to sharpen up the organisation and reduce costs. To reduce risk through increased integration and to build on our growth platforms.

Let me start with the transformation of British Gas. Since I last presented results to you, British Gas has reduced prices twice for our residential customers and we are now firmly positioned as one of the cheapest providers of gas and power. In fact the supplier with the lowest absolute dual fuel tariff in the shape of our click energy offering. We have also implemented our Essentials tariff in March to help our most vulnerable customers with their energy bills. Then two weeks ago we announced a tracker product so that those customers who wished to can participate in the changes in the wholesale price on a quarterly basis. All of our customers are now on the new billing system and with the new system comes new capabilities. For example our second price decrease was announced and executed on the same day. We have also been able to introduce regional gas and electricity pricing which enables us to be much more targeted in our customer propositions.

Another crucial element of course of the transformation is customer service. And although we have by no means reached our destination on customer service levels, our aim remains to return to being amongst the best in the industry here. And we have been making progress and the extreme focus we are placing on fixing the problems is beginning to make a real difference. By way of example, our average time to answer a call was around 60 seconds in July, almost a 50% improvement on where we were in January. And it is below 30 seconds this week. We are responding to email correspondence 70% faster than we did. We are handing off fewer customers from one agent to another and this can make a huge difference to the customer experience. And most importantly, complaint levels are falling week after week. Earlier in July we also launched a much more friendly internet offering, britishgas.co.uk. and that replaces the old: house.co.uk and already we have sold 9,000 products across that site.

Costs are another critical component of this transformation. In terms of our overall cost reduction target, as Nick mentioned, we have a target of £200 million in British Gas Residential cost reduction. And you can see here that we are making solid progress. We have also separated out the cost of the energy efficiency commitment from controllable costs to make it even clearer. We did however make a very conscious decision at the beginning of the year to increase our investment in service levels by some £60 million, therefore we expect the full year OpEx reduction in 2007 to be £140 million with the balance of the savings coming out in 2008.

The result of a much more competitive offering and better service is that we have once again begun to add customers in British Gas. After a tough first quarter when we lost over 250,000 accounts we have been growing our customer base steadily. Since we announced our first price drop in February, our account sales have averaged over 65,000 a week. Up around 15% on the same period in 2006. And the number of people notifying us that they wish to leave British Gas has fallen sharply and with improving service levels we expect it to fall further. Second priority we outlined is to create a more efficient and leaner organisation.

Although this is a constant journey, here too we have made some significant progress. Phil is already moving ahead rapidly with a new structure within British Gas where we will create smaller and more manageable P&Ls. The first of these separates out the pre-payment business which we now call Pay As You Go. We will do the same with other areas of that business. This gives greater visibility of the end to end processes, improves our understanding of the customer experience and creates greater accountability.

I have redesigned our Executive and carried out a full skills review across our top managers to both identify gaps and development requirements and also to maximise the impact of those with the highest potential. In doing so we have been able to reduce the size of that group by a third. I have implemented a robust three year planning process which enables us to look in far greater detail at our financial performance further out and to track and manage costs over time. And as Nick mentioned, we created a separate P&L for our UK power generation fleet. This too will ensure that we maximise profitability. And we measure ourselves the same way as a specialist merchant generator would.

On the cost side, I have implemented rigorous and detailed quarterly cost reviews for every business unit which will systematically drive our costs down and keep them down. The headcount reductions that we promised at the end of 2006 are being delivered. We reduced our UK headcount by over 1,000 in the first half of the year and will reduce it by an additional 850 by year end.

We have also moved forward in other areas where we saw potential. The first of these is to completely outsource our data centres and IS support team for an annualised saving of over £9 million. There is still a lot we can do on cost and I assure you we intend to keep the pressure on here.

The third element of the strategy is to reduce risk through increased integration. In gas we have set ourselves the target of covering 50% of our retail load with a combination of our own production and a diverse set of long term contracts. We continue to carefully examine a range of opportunities to meet this objective. We are continuing to build the necessary skills base an international footprint in Centrica Energy to capture new sources of piped gas and LNG. And our acquisition in June of two more exploration blocks in Norway brings our total to 12. Some of these blocks are near infrastructure are easier to develop. Some are more remote but offer larger potential. We also secured additional LNG import capacity at the Isle of Grain and we now have access to 6 billion cubic metres of capacity there. And we launched an appeal to secure planning consent for a new LNG re-gas terminal at Canvey.

Our access to import capacity together with our customer base are key advantages in our discussions with national oil companies who wish to bring LNG into the UK market. We are in active discussions here but as I indicated in February, arrangements like these do take time. In the meantime we are also continuing to access additional sources of pipeline gas.

In power our progress has been more visible. We have three large scale construction projects underway at Langage, Lynn and Inner Dowsing. Along with the 50% equity in the Braes of Doune wind farm, this will add about 1.1 GW of low emissions generation to what is already the lowest carbon footprint fleet in the UK. During the first half of 2007 we invested £120 million in these projects and we are committed to a further £500 million to bring them to completion over the next 18 months. The Energy White Paper's proposal on banded renewable obligations certificates will also improve the viability of another 1.3 GW of wind projects that are in the early planning stage.

We have also commenced the viability study for an 800 MW clean coal and carbon capture project at Teesside. The economics here are challenging and will require Government support. But this could be a realistic technology to address the longer-term climate change and power supply needs of the UK.

The fourth component in our strategy is really building on our growth platforms and these are all performing strongly. British Gas Business had an exceptionally strong first half and although the numbers are supported by the favourable hedged positions that Nick described, the results are not just due to a benign gas price environment. Here too we are continuing to grow the customer base. Our sales levels were higher across all customer types. Margins and operating profits were significantly higher than the same period last year. And we made real progress in rolling out a differentiated level of service with dedicated account managers. I believe this is already beginning to make a real difference with SME contract renewals running at over 95% and churn across the tariff book below 5%.

British Gas Services built on a very strong finish to 2006 with operating profit for the first half of 2007 up 43% year on year on the back of much improved operational and service metrics, especially through the winter. We are answering the phones faster, increasing the number of jobs performed and improving on our scheduling of appointments. Here too we are committed to grow the customer base, both in central heating care and the secondary products, home electrical care, plumbing and drains and kitchen appliance care. And the signs here are very positive. This business is going from strength to strength.

North America had another strong six months. In local currency we saw excellent growth in top and bottom line. A recent re-organisation here along business rather than geographic lines gives us even clearer visibility and accountability for performance. Much of our recent revenue growth has come from the commercial energy supply arena. Once again year on year revenue was well ahead. The more established contracts are profitable with the bottom line held back only by the expense involved in acquiring the newer business. And we would expect to break even here in the second half of the year. In the Texas market we have been through a lot of change recently, especially with the ending of the price to beat regime. And although this does squeeze margins, the Regulator now appears committed to a fully competitive market going forward.

We have also seen strong profit growth in the wholesale energy segment where we have built up our people skills and secured profitable positions in key pipelines and capacity from wind and storage assets. And although 2007 will be materially impacted by movements in the exchange rate, overall the landscape in North America continues to look positive. As I said in February, we will not constrain the North American business to its own internal cash flows, if appropriate opportunities do come up.

Another area of growth that we talked about in February is the green space and energy efficiency. In March we launched British Gas New Energy. I don't claim to know precisely how big this can be, but what we will make sure is that we are the market leader in providing energy efficiency advice and the products and services that accompany it. We are already the supplier with the lowest carbon footprint through our gas and wind generation assets. And we have a unique knowledge of the current state of the UK's housing stock gained through our 1½ million responses to our Energy Savers Report. The first revenue stream for this business will come through Energy Performance Certificates, EPCs. And we now have 150 staff in training to issue EPCs which were required from yesterday for all homes sold in the UK with four or more bedrooms. Over the medium term this new energy business will develop substantial opportunities in conjunction with British Gas Residential, where we have recently launched this week two new green energy products and British Gas Services where we are the largest installer of A-rated boilers. And we also of course have a close relationship with companies that are developing new technologies for energy efficiency.

So in summary, it has been a strong first half and this provides us with a good platform for growth. And we currently envisage that the second half will support expectations for the full year. The wholesale price for this winter however remains the key uncertainty. It is considerably higher than the price that we are seeing today. Based on the forward curve, British Gas Residential margins in the second half are likely to be at lower, but more sustainable levels than the first half. We will not be diverted by the affect of short-term commodity movements. We will manage through the cycle to invest in bringing low carbon, reliable and affordable energy to our 22 million energy customers at home and abroad.

We will continue to focus on the priorities that we set out in February to deliver a step change in the performance of this business. Under the transformation of British Gas with Phil's leadership, work has just begun. But we have made strides in our customer offering and we are once again adding customers.

Recently our service levels have started to improve, but we still have a lot to do here and that remains the key priority for management in the second half. We will continue to sharpen up our organisation and reduce costs until we are the lowest cost to serve provider in the marketplace. And with regard to increased integration, we are making good progress with the construction of new power generation facilities. Negotiations on new sources of gas are ongoing, though typically these do take time.

And our growth platforms are performing well. But well is not always good enough. We want progress here to be even more rapid. So I'd mark our report card as, "making strong progress, but has the potential to do even better".

Thank you very much.

Roger Carr

Thanks Sam. We will do Q&A now and normal procedure, if you could say name and firm and the buttons for those who have not been here before, you have to press to go on and press to go off so the next person can come on.

Questions and Answers

Q1. Colin Pollock, Credit Suisse

On the cost savings, I would just like to understand what is actually driving these cost savings first of all. And what does the £60 million that you are spending this year buy you in terms of the cost savings? And what is left to do on the billing system? What are the remaining challenges to get this thing working so that we can put a line under that and move forward? Thanks.

Answer: Sam Laidlaw

Colin, very good question. Firstly the cost saving, what is in the £60 million? We took a conscious decision at the beginning of the year when it was clear we were having difficulty migrating our 16 million customers onto the new billing system, to add 800 call centre agents. That is a big component of it. The cost savings are predicated on clearly the new system working and also calls coming down as everybody migrates onto the new system. We expect that to happen later this year. We are already starting to switch off a lot of the legacy systems. That gives us a significant cost saving. And as we move forward, as our average time to answer calls and number of calls decreases, actually improved service drives lower costs. This is not a business where if you like increased cost is required for higher service. If you get the service right we will get the costs out.

Now in terms of where we are with the new billing system. All the customers are on it, it is operating. We have driven out a large number of exceptions that we had and the result of that is that actually when we look at all the back office metrics they are going in the right direction. The lagging indicator is always customer complaints, but even that indicator is going in the right direction as well, down 25% as I showed you. So I think we are definitely through the difficult patch, but I think it was absolutely the right thing to do to invest that additional £60 million and we are still confident that we will get the £200 million out as we take people out of the back office to front office and also switch off the legacy systems in the balance of this year and early next year. Phil is there anything you would like to add to that?

Answer: Phil Bentley

I think Sam has really covered it off. The point about the £60 million there is that we were planning more reductions that we weren't then able, in terms of people, to execute against. But clearly we then, not only not made the reduction, we have actually had to add to it as well. I think, if I take something like pre-payment processes that were forced into a billing system that read from a bill process rather than a meter reading process. And we are still re-engineering some of the pre-payment processes and I think that is the point about creating these P&L's is that we get closer to our customers and recognising that different customers have different channels to access them and have some different processes, so that is still going to be an ongoing piece of work that is going on. And as Sam said, this time last year, call volume was increasing because we were migrating more customers and having more errors if you like, on the system. Call volume now is starting to fall and that is not just a seasonal affect, it is lower for the season as well.

Answer: Nick Luff
That £60 million is not a restructuring charge, it is extra running costs this year that we expect to come out next year. There shouldn't be any cost to achieving that though because of the relatively high staff turnover. We expect costs to come down next year without any exceptional costs as a need to do that.

Further Question: Colin Pollock, Credit Suisse
So just to clarify on the staff numbers that you mentioned separately in the presentation, those are core staff and the 800 are extra which will then leave?

Answer: Sam Laidlaw
They will come out as well.

Q2. Ian Mitchell, JP Morgan:
Just staying on the customer service side of things. Clearly you are very competitive now on pricing, but when you look at the customer losses, which were made when prices were being raised over the last two years, and you look at the gains that have been made in Q2 - there is a mismatch. Would you expect those net gains to be increasing? Do you think the customer service is holding back on you gaining customers? Or is the competitive landscape just different now? And secondly, you are talking about moving to best in industry customer service. Do you have a time frame when you expect to reach that?

Answer: Sam Laidlaw
Both your questions Ian, I think the first question is can we regain customers at the same rate as we lost them last year? And I think the honest answer is that it will take time because I think the brand did suffer some damage but I think we are starting to see in recent brand indicators certainly considerable improvement in the preference for British Gas. I think there is increasing recognition that we are the cheapest and our click energy product is the cheapest in the marketplace. High levels of service we do believe will result in higher levels of retention and you know we are adding 65,000 customers a week but our notification levels are still running too high and that is the area that we will I think improve upon with higher levels of service coming through. And as we are seeing today call centre waiting times have sharply improved and I think that recognition of better service will drive better retention rates.

Q3. Andrew Wright, UBS
I wanted to ask a question about your European businesses. There has been quite a rapid pace of change in terms of legislation and regulation in Europe with the European Union being more forthright in enforcing the existing directives and prospect of more complete unbundling. Is that changing your view about what you might do in Europe? Are you looking to expand that or is that still very much on hold?

Answer: Sam Laidlaw

I think strategically we would still like to grow our businesses in Europe and we have been very involved in the unbundling debate and I think we can certainly see a very active position being taken by the European Commission and we look forward to the third package of directives coming out in September which I think will certainly drive whether it is full ownership unbundling which we are advocates of or whether it is some form of large regional ISO's. I think the momentum is for full ownership unbundling and we saw that in the European Parliament. So that will actually I think you know potentially create some opportunities, but I think we have to be cautious and realistic here because I think the timetable for that type of legislation in Europe is not going to be instantaneous and I would suspect there will be a period within which incumbents are allowed to implement it so it could take some time. And it is because of that that we are cautious in our plans. Not because we don't want to do it, but I think we just want to be realistic about the timetable that legislation is likely to come through, particularly as we move into the Portuguese Presidency in Europe.

Q4. Ian Turner, Deutsche Bank

In the industrial and wholesaling segment, you disclose in the statement about roughly a third of the volume in that segment went last year because of the LTI contracts finishing. Is there a sense with that business that you have got more of those contracts that are likely to finish in the next couple of years and ultimately that business effectively withers away and you don't have this big swing thing there? Or is there more to industrial and the wholesaling business than just the LTI contracts?

Answer: Sam Laidlaw

It is a good question. The answer is those contracts do tail off by 2009/2010. The actual volumes in any one year are somewhat dependent on the price because what happens is, clearly with higher prices, higher wholesale prices there are greater takes under those contracts than with lower prices. But the annual contract volumes, the base volumes do tail off over the next three years.

Q5. Peter Alison, Citigroup

Three parter I am afraid, but simple ones I hope. Firstly just on the head count reduction, they are all full time equivalent jobs are they?

Answer: Sam Laidlaw

They are all full time jobs and actually the difference here between roles, positions and full time equivalent is very small. There are small timing changes month to month, but they are all. You can translate that into jobs if you like.

Further Question: Peter Alison, Citigroup

One for Jake probably on the damage to the CATS pipeline. Is that causing you any problems firstly near term over the summer, will it impact on storage levels in Rough and elsewhere? How worried are you if it doesn't come back in September?

Answer: Jake Ulrich
I think the initial reports were exaggerated, end of the year type thing. You would have to ask Grant how it is impacting Rough. Clearly I can't say too much about that. But I don't think it will have a huge impact and again we see Ormen Lange Langage reports are fairly positive. And I expect that gas to start flowing a bit earlier than we had initially expected. So all in all I think a slight over reaction, price wise. I mean you see things softening now.

Further Question: Peter Alison, Citigroup
And a final one, just on the North American business. If you look at the very back page, can you just tell us where the key pressures in the margins in Texas are going to appear in the new business segment in mass market energy?

Answer: Nick Luff
Mass market energy covers most of the residential market and small business customers. So it will appear in that segment.

Further Question: Peter Alison, Citigroup
And can you give us a feel of the £88m in the first half, how much of that is in Texas?

Answer: Nick Luff
Two thirds of it.

Q6. Nigel Hawkins, Libertas Capital
Three quick questions if I may. Could you first explain the background to the contract at Milford Haven which seemed to be cancelled very quickly? Secondly you may have seen Clipper Wind Farm results recently and concerns about turbine shortages. You have got a significant wind investment programme, are you going to suffer do you think from turbine shortages? And thirdly just more generally, in terms of further acquisitions, would I be right in thinking your focus is now far more in America than rather than in Europe. There was a tantalising throw away line I think about your American cash flow and any acquisition might exceed that. But is that the message on acquisitions we should go away with?

Answer: Sam Laidlaw
Nigel, three good questions. Let me start with the Milford Haven contract. This was a contract I think that you were referring to with Petronas where they were due to supply some LNG to us. We both agreed and it wasn't by the way sudden, it became increasingly clear over a period of time that the conditions precedent weren't going to be fulfilled and therefore we both agreed the right thing to do was to cancel that contract. We continue to talk to Petronas who are of course also important shareholders about a whole range of different areas for collaboration. And we continue to enjoy a very good relationship with Petronas. So I think it was by mutual agreement. The important point is that for the near term we didn't actually see, given the additional volumes of pipeline gas that we have got coming into the UK for this winter, we did not see an immediate need for that contract. I think

that is Milford Haven. Your second question was around turbines. And yes you are absolutely right, the turbine market is tightening up. We are in the fortunate position of having entered into commitments for turbines and Jake I don't know if you want to talk briefly about what we have already done, but basically for Lynn and Inner Dowsing, the contracts have already been met.

Answer: Jake Ulrich
Yes for phase one we are okay, we're in good shape. Those are all under contract. We are currently in negotiation for Phase 2. We haven't committed to Phase 2 yet but we are in discussions to reserve those. Again it is tight, there is quite a demand in North America right now. As you are aware one of the manufacturers has dropped out of providing offshore turbines for the near term. So it is more of a problem for the offshore, but we are in pretty good shape.

Answer: Sam Laidlaw
Longer term I think we are looking at significant increases in turbine manufacture capacity in India and also in China but particularly in India. I think your third point was around are we signalling significantly more acquisitions in the US rather than Europe? I think what we are signalling is that the progress in Europe, much as we would like to do it, may be slow and therefore if we have surplus cash flow there maybe more opportunities, if they are value enhancing and value creative in North America either in blocks of customers or possibly in generation assets, and we are not constraining ourselves to the cash flow if we see value.

Q7. John Musk, Lehman Brothers
Can I just ask two questions, one on the Balance Sheet and where we should expect net debt to be heading towards at year end? I am assuming there are more cash inflows to come in the second half. And where does that therefore leave you in terms of headroom? Are you precluded from doing both shareholder returns and acquisitions? And then the separate question, I will come back on the separate question that at the end.

Answer: Nick Luff
You are right. We should generate capital in the second half, particularly with the seasonal movements. So we would expect debt to be down on the current 950 ish by perhaps a couple of hundred million. It is hard to be precise, it depends what margin call situation we are in at any moment in time, given the commodity price movements. But yes you are right again that will leave us with significant headroom to fund the upstream investments that we are seeking. You know it is difficult to put a precise number on that. It depends on what we spend the money on, what it does in terms of the earnings that those assets bring with them and what it does to the risk profile of the Group. That can also create more headroom. But clearly we have got a lot more headroom today than we had when we had the debt of £2 billion a year ago. And is there scope to do both returns to shareholders and upstream investments, then yes, depending on the scale of the upstream investments.

Further Question: John Musket, Lehman Brothers
And sorry the second question was, you mentioned about a return to more through the cycle margins in the second half. Is that assuming no tariff increases and the current forward curve?

Answer: Sam Laidlaw
That is correct yes. That is based on the market as we see it today, assuming no price increases.

Q8. Jamie Tunnicliffe, ABN Amro
You mentioned that you have sharpened up I suppose your financial appraisal I think and whole approach. Just interested in whether that has at all changed anything in terms of the way you think and approach your desire to become a more integrated business?

Answer: Sam Laidlaw
I think it has actually changed, it is a good question. I think it has changed the way we allocate capital. Instead of having a preconceived view that each business will spend a certain amount of capital depending on its own cash flow, basically all capital goes into a centralised capital allocation system and therefore it gives us I think a much better chance of optimising returns through the cycle both in periods of high and low gas prices. And so I think in that sense it has changed things yes. And it gives a much more integrated approach if you like with one central funnel looking for superior returns rather than individual buckets.

Further Question: Jamie Tunnicliffe, ABN Amro
And in terms of then thinking about acquiring a gas asset or a power generation asset, obviously you look at the stand alone return on that. How do you assess the benefits that brings to the business then in terms of the mix that you want to have, you know your desirable mix in the future that you are trying to look at?

Answer: Sam Laidlaw
Well you are right, we look at the stand alone returns of the project, but then we look at what it does to the risk profile of the Group as a whole. You know, is it ultimately going to reduce our cost to capital because it is going to take risk out of the business? Or is it going to take us in the other direction but have superior returns and clearly if it was higher risk we would be looking for higher return.

Q.9 Edmund Reed, Cazenove
I have a question on the terms that you are looking for on gas and supply contracts. From memory I think most of your long term contracts at the moment are based on month ahead NBP. I just wondered given that the UK gas price has diverged so significantly from the oil price, whether gas producers are more reluctant now to enter into month ahead NBP contracts?

Answer: Jake Ulrich
NBP does not look attractive to most producers and taking a short term view, oil based contracts are. So I don’t expect us to get too many full NBP

contracts at this time, especially you will see I think fewer LNG coming through in the next few years other than those winter periods where we do get to significantly higher prices. So we are looking at a number of different things, where we would nominate or the seller would nominate parts of the contract, but it is going to have to be different than the straight NBP at this point. Again that depends on the flexibility that the producer has. If it is UK North Sea pipeline gas NBP is the only way to go. If it does have flexibility and ability to go into continental Europe or go into an LNG train that is a different story. So it does depend on the source.

Q10. Ajay Patel, Dresdner

Three questions if I may. This may be already known, I am not too sure, but could you explain why the Morecambe Bay pricing formula was renegotiated? Secondly on the working capital you experienced quite significant improvements half on half. I guess with the current forward curve and where supply bills are at the moment, could you give us the order of magnitude of working capital benefit for the full year? I think that will do actually for two questions, thanks.

Answer: Sam Laidlaw

I think we announced certainly at the full year that we had renegotiated the Morecambe Bay contract and this was actually a rather unique one off contract with the revenue where there was a considerable disparity between the current price and our tax reference price. And what we have actually done is bring the two into line. When prices were going up, that disparity worked to our advantage, but when prices were coming down it worked considerably to our disadvantage. So now we are basically on the same tax reference basis as most fields in the North Sea, much closer to it anyway, that I think certainly makes the business much easier to model, it makes it easier to predict from our point of view and it has also resulted in us being able to run Morecambe for longer at lower price levels. I will let Nick speak on working capital?

Answer: Nick Luff

It is difficult to be precise as we said. It does depend very much on where prices are at the particular time around year end and particularly on margin calls etc. I think we have had most of the benefit from the lower prices in the first half, so if you assume that is sustained in the second half, depending on what happens to the wholesale prices of course.

Roger Carr

Any more? That's very good. Well thank you all very much for coming. We wish you a good holiday and probably a larger group next time. Thank you.

End of Presentation