Centrica Interim Results for the period ended 30 June 2009

Presentation Transcript – 30 JULY 2009

Roger Carr - Chairman

Good morning ladies and gentlemen and welcome to the Centrica Interim results on what I know is a busy day for many of you today.

As usual, in a few moments Nick will review the details of the financial performance and Sam will focus on the operational highlights and the strategic developments of the business.

I think in summary, our overall performance during the last six months has been good and the weighting of results clearly heavily influenced by movements in the wholesale market.

Sales and profits of the combined British Gas have been good. Lower wholesale prices enabled us to reduce retail prices, which in turn increased our competitive edge and strengthened our overall market position.

These factors were underpinned by further improvements in customer service and the continued attack on costs, as we fuse the two British Gas businesses together. These actions provided the foundation for an encouraging sales performance and the delivery of a satisfactory margin. Upstream the fall in wholesale prices took its toll on output and profits, but on a positive note reduced the overall tax charge for the Group.

Patience and determination in negotiation paid off in securing an improved deal with EDF for our 20% stake in British Energy for which we received overwhelming shareholder support. We now await the regulatory approval. Our electricity hedging position will be materially improved by this agreement and we continue to pursue a stronger position in gas with E&P acquisitions, and of course our cash offer for Venture Production.

Operationally, the North American business performed well but the results were hit by our decision to take a more prudent view on customer debtors, which did trigger a one-off provision.

The North American business is now under new leadership and with the exit from Europe shifting the geographic weighting of the Group, North America will be an increasing focus for us going forward.

Under Sam's leadership, the future will now focus on concluding the British Gas transformation, securing the upstream hedge through the investment opportunities that we have within our business as well as the carefully targeted acquisitions that we have in our sights, and also developing North America as an integrated business, similar to the UK model.

Much has been achieved. There is more to do, but I am very confident that the next 6 months will continue to demonstrate the strength of the management team and the robustness of the integrated business model.

I will now hand over to Nick.

Nick Luff - Group Finance Director

Thank you Roger. Good morning everybody. As Roger said, obviously the key feature of these first half results was the relatively low commodity price we had in the first half of this year compared to the first half of last year. But also relevant to the numbers, as I will explain when I go through, is the fact that those low prices were coming off very high levels in 2008 with the impact of hedging delaying the effect on both the downstream and the upstream businesses.

If I start with the Group numbers here and the first point to make is that that top box relates only to continuing operations As Roger mentioned and was in the announcement this morning, following the SPE sale, we have decided to exit from our positions in The Netherlands and in Spain. As a result all these European businesses are now classified as discontinued and excluded from those main continuing numbers.

Sticking with the continuing numbers you can see that revenue is up some 20% to £11.7 billion. And that reflects the high UK retail prices following the price increases last year. It also has a higher revenue number in for North America mainly due to Foreign Exchange (FX) rate movements, but also due to the Strategic Energy acquisition energy C&I business made this time last year.

Group operating profit was down by about 5%, and I will come back and give you some more detail on that in a second but the tax charge was also down. You can see the effect of tax rate was down from 58% to 39% in line with our forecast for the full year and reflecting the shift in profits away from the more highly taxed upstream.

The net effectively of all of that and coming to the bottom, this includes the discontinued European businesses, earnings up almost 30% to £537 million. Of course we did have a lot more shares outstanding during the first half of ’09 compared to the first half of ’08 as a result of the Rights Issue which prefunded the British Energy deal. As a result of more shares on issue the increase at earnings per share was reduced. That was up 4% to 10.5 pence per share. The interim dividend as usual we have set at 30% of the prior year full year dividend and that works out at 3.66 pence per share.

So if I go to the breakdown of the operating profit, you can see immediately the shift from upstream to downstream and also the poor result from Direct Energy due to some one-off factors which I will come back to. Downstream, in the UK, British Gas increased profit by over 50% to £476 million. The main driver of that, as you can see from the table at the top left, is the improved result from the Residential Energy supply. But we also had good results from Business Energy supply and from Services.

On the Residential side, as we can see, revenue was up significantly despite the fact that we reduced prices during the first half of ’09, but of course the price increases last year meant that unit revenues are actually up quite significantly, in gas by some 30% and in power by 10%. Consumption was actually down despite the colder weather at the start of the year as consumers reacted to those higher prices and also the underlying effect of energy efficiency measures coming through. However even with those lower volumes our commodity cost, as you can see, actually rose with hedging delaying the benefit of the lower wholesale prices coming through. Nevertheless the combination of those retail and wholesale price movements and the hedging was still positive and that is what drove the increase in operating profit up to £299 million. And that was despite some significant increases in non-commodity costs, in particular in bad debt.

BGR’s margins came in at 6.8% for the first half. We are looking for something similar in the second half with the beneficial impact of lower commodity prices flowing through and offsetting the retail price reductions and also the likely continuation of consumption falls. At this point of the year, the main variable of course is consumption and what impact the weather has on that and also how that interacts with the commodity price.

Coming to the other two businesses in British Gas, BGB and BGS. You see they both had a strong first half. They both increased their revenue base despite the difficult economy. In BGB’s case there was a significant increase in customer numbers, mainly in electricity as we added customers through the E4B and BizzEnergy deals at the back end of last year, and that more than offset lower gas consumption as the recession hit demand from our business customers.

Services they grew product holdings, particularly in Home Electrical, despite the weak economy. And both businesses, both BGB and BGS, are set for strong full year results ahead of consensus.

And finally on British Gas, on operating costs you will see on the chart on the bottom right, controllable operating costs for British Gas as a whole down some £20 million as we continue to focus on efficiency, and looking forward of course we have the cost reduction initiatives coming out of the British Gas integration and we are looking for those to drive cost savings of £100 million on an annualised basis.

Moving to the upstream, Centrica Energy’s results down by about a third to £332 million although if you take tax into account, the effect was much reduced. You can see from the table on the top left, the fall came entirely from lower gas production profits. Top right, the average selling price for gas slightly up, that is the benefits of hedging and of course the flip side to the hedging in the downstream. But if you go bottom left, you can see the volumes we produced were down by about a third as we chose to buy from the market rather than produce out of Morecambe for much of the period, and that is of course what drove the overall gas production profits.

Looking to the second half, the hedges will unwind and average selling price will come down and on volumes we are currently forecasting something similar to the first half, although if gas prices stay low we may keep Morecambe shut for some time. Either way gas production profits are expected to be down substantially in the second half by more than the current consensus numbers will imply.

On the other hand power generation moved into profit, £41 million of profit against a small loss last time, albeit the return on some of the thermal fleet do remain low. As you can see on the bottom right chart, the volumes we generate were actually slightly down, but with a combination of better reliability and forward selling, meant that we captured higher average spark spreads and of course we had the first time contribution from the two new wind farms at Lynn and Inner Dowsing. In the second half we are looking for a similar result from power generation, with Langage the new power station coming on stream. It's commercial start date is in December, so it won't do much this year, hence a similar result second half to first half.

And my final comment on CE is on the legacy owned I&C contracts. You can see there that the loss there was much reduced, reflecting the lower wholesale prices, and if we look out at the forward curve and the hedge position we have got, we are expecting losses to continue at that sort of level through the rest of this year and into the second half for 2010, but not beyond as the main loss making contracts expire.

Moving to North America, the Direct Energy result was disappointing, given the commodity price environment, the upstream was down significantly as you would expect. If you look at the bottom right, you can see that although we maintained gas production volumes, the average selling price reflecting very low North American gas prices were down significantly. And also very low spark spreads in Texas meant the power stations there made only a very limited contribution.

In normal circumstances we would have expected the downstream mass markets business to cover the shortfall upstream, however we did have a one-off charge relating to bad debt which held us back there. Underlying performance was actually quite strong, as you can see customer numbers were up and we do have higher gross margins. But with the weak economy impacting debt collection rates, we have reviewed our bad debt provisioning and as a result written off £45 million of final debt in Texas. And obviously that hit the result which otherwise the mass markets would have shown a healthy increase.

More positively the C&I business did perform strongly. You can see the benefits of the Strategic Energy acquisition coming through and also with capital constraints, impacting some of our competition, we were able to drive for higher margins. For the full year, obviously Direct Energy result will be hit by the one-off bad debt charge, but otherwise it is trading in line with expectations. Clearly upstream will continue to struggle in this environment with low commodity prices, but is a good environment for the downstream business and of course we are helped by the FX rates compared to last year.

Centrica Storage had a very strong operational period in the first half of this year and the price for the SBUs we sold this year have actually been quite strong, the summer winter differential widening again. These particular results of course for the first half are driven mainly by last year's SBU price and hence the lower profitability. If we look at the second half SBU revenue will be up, albeit last year we did have some cushion gas sales in the second half which are unlikely to be repeated this year.

I will move now to cash flow and Capex. Starting with the cash flow you can see cash flow remains strong. EBITDA stable at about £1.25 billion. Working capital and margin calls are broadly flat this year, in contrast with last year when of course we had that very large working capital outflow and a very large margin cash inflow in the first half, more than offsetting it.

This year is a heavy year for Capex. In the first half alone we have spent close to £1.7 billion and I will come back on the next slide and give you some details on that. And that high level of Capex meant that the net debt level for the Group was pushed up to close to £1.9 billion, albeit it is considerably lower if you adjust for the £600 million margin cash out position.

Here is a breakdown of the Capex and you can see we are investing significantly more in the business this year at the organic level. Most of that increase going into UK gas production and in particular we are spending more on development, including on the assets we acquired in the Newfield deal back in 2007. The acquisitions number there in the first half, the £1.07 billion, includes the €600 billion we spent buying 25.5% of SPE. It also includes the capital contribution that SPE itself made to the Pax Electrica deal and it includes the £250 million or so we spent on buying shares in Venture up until the 30 June.

For the full year figure for acquisitions, we have then added in the British Energy deal, net of the SPE sale. However it does not include any other acquisitions we might make and in particular does not include anything more for Venture. We are of course aiming to spend another £900 million or so buying the 70% we don't already own.

So in summary then, a decent set of first half results, driven by particularly strong performance in the UK downstream, offset by a lower contribution from the upstream as commodity prices fell. We do have a stronger financial position, ready to finance the British Energy deal and to make further investments to strengthen the business. Obviously the full year earnings will depend to some extent on which acquisitions complete and when, but overall the existing business is trading in line with expectations, albeit we do have to make up for the one-off hit we have taken in Direct Energy.

And with that I will hand you over to Sam.

Chief Executive's Review
Sam Laidlaw - Chief Executive

Thanks Nick.

Good morning everyone. I know it's a very busy day in the Corporate reporting calendar, so thank you all for coming. It is marvellous to see what a little Corporate activity can do for attendance at these occasions.

The commodity markets in the first half, as Nick said, once again I think provided a real challenge for all energy suppliers and following the extreme peaks we had last year in crude prices, this year we had significant troughs and gas and oil prices have delinked. Crude, at $66 a barrel, is now well above its starting point in January, as production cuts from OPEC have had a real impact. On the other hand, short term gas prices, although still high for this winter, have weakened and now trade at a substantial discount to oil.

This price volatility, I think, is a salutary reminder of why we are driving our strategic agenda of greater efficiency and greater integration at Centrica, making this business much better able to withstand commodity price volatility, both upwards and downwards, in a competitive market.

And with this in mind let me take you through the results of the first six months and the progress we've made and give you some thoughts as to where we go from here.

The underlying Group result in the first half was good. Although we increased our capital base by some 20% at the end of last year and we have yet to put these proceeds to work, we still managed to deliver a modest increase in earnings per share.

Centrica has proved to be a relatively safe harbour in a global economic storm. The improvements we have made in our service levels and our cost base have enhanced our competitive position. And we have made material progress against our strategic objectives. In British Gas, for example, the next stage of transformation is now well underway.

In Residential Energy our customer service, continues to improve, to the degree that we are now on the front foot and see it as a positive differentiator.

Our improved processes and technology mean that our average speed to answer customers' calls is now running constantly below 30 seconds and we have reduced the number of abandoned calls by over 75%. As a result, Ombudsman complaint levels are now well below the industry average.

We have also transformed the British Gas website, and we now have 1.4 million customers servicing their 2.1 million accounts online.

This year British Gas led prices downwards with 10% drops in both gas and electricity. These reductions have given us an excellent price message and provided us with strong sales momentum.

And the result of all of this is that recently we began to grow our energy customer base again. You'll see from the chart on the bottom right that the trend continued into July. Over the last three months we have added 66,000 energy accounts and we are now in positive territory for the year as a whole.

And as Nick showed, we have been doing all of this while making reasonable margins, towards the higher end of our target range. Whilst bad debts are having some adverse impact, the substantial cost reductions of over 20% we have achieved over the last three years have improved our competitiveness.

And in British Gas Services it has also been a great story. And perhaps, to some of you, a somewhat surprising one, given the ongoing weakness of the economy. This business accounted for around 12% of the Group profit in the period and over 15% of post tax earnings.

And here it's also a case of great customer service and strong operational performance. Our engineering effectiveness is up by 10 percentage points. We are keeping more appointments and carrying out more Annual Service Visits than ever before. And as a result our Net Promoter Score, the key measure of customer satisfaction, is at an all time high.

And we have continued to push on here by introducing a 100% call-ahead service for customers which provides them with greater flexibility and assurance on the day of their visit.

And of course we have grown the top line, with the strongest growth coming from the newer and higher margin products of Home Electrical, Kitchen Appliance and Plumbing and Drains through the now internationally famous Dyno brand, following the puppy rescue last month.

And British Gas Business is also becoming a very material contributor to the bottom line, with underlying growth in profits of over 30%. And it's also worth remembering that the second half result in this business is always substantially higher than the first half.

Here we have now fully integrated the 2 SME customer businesses we acquired at the end of 2008 and have also kept our customer retention rates high.

And we have been extremely proactive in minimising the impact of the economic downturn by rapidly identifying sectors and specific customers who are struggling, and putting in place payment plans such as monthly billing to assist with the management of their cashflow.

We have begun to make our mark in the commercial Services market with the acquisition of 2 small energy management companies. We intend to build this capability and, given that we have a commercial energy customer base of over 1 million accounts, we believe this provides a real growth opportunity.

We are also leading the market in SMART meters. To date we have installed 45,000 and expect to install a further 20,000 this year. And the early indications are that this has a very positive effect on customer satisfaction, with customer queries following the installation of a SMART meter going down by more than half.

So each of the areas of business within British Gas is performing strongly. But the big story here is the broader integration of the business into One British Gas, under the leadership of Phil Bentley.   We now have the One British Gas leadership team in place and have combined the support functions to provide greater visibility of costs and performance. This will enable us to take out the further £100 million from the cost base that Nick referred to earlier.

Our customer targeting and the prioritisation of sales is better. Our sales of energy products through the services call centres are up by around 50%, and we have already doubled the proportion of our services sales which come through our energy channels.

The new structure better enables us to run joint promotions. Following our electricity price decrease this year, we successfully trialled a promotion of our Home Electrical Care product to our electricity customers. And we have relaunched our marketing campaign to support the combined businesses.

We are solidifying our position in the households of Britain. Total customer account numbers across British Gas are up by almost 120,000 to 25 million. And the number of households which take both an energy and a services product is up by 76,000 since the start of the year.

But this still means that out of the 12 million households we serve, still only two million take both an energy and a services product. So growing this number remains both a great opportunity and a strategic goal. And in doing this we will continue to increase the value of the customer base through higher marginal revenue and lower churn. You'll see from the slide that this was the pattern in the first half, when we grew in dual fuel and higher value customers. British Gas is a great story and we will continue to move it forward rapidly from here.

Now let's look at the progress in upstream, under Mark Hanafin's leadership. In gas we have continued to develop our portfolio. This year the organic development work we are carrying out will move around 100bcf of reserves from development to producing.

As part of this, at the Newfield properties which we acquired at the end of 2007 we have now delivered gas from the second well at Grove and successfully tested the third. And at Seven Seas, which we acquired as an early stage development project, we have completed the well and experienced very encouraging flow rates.

On Venture Production, as you will have seen our announcement earlier this month, we now own 29.9% of the ordinary share capital and have made a cash offer for the whole company. Based on published production rates, a successful conclusion to this deal would add almost 15 percentage points to our energy hedge, taking it close to 60%.

The LNG market is also developing very quickly and the UK has rapidly become a key destination as demand has dropped away in Asia and North America. And by the end of 2010 we expect to see over 60 million tonnes of additional annual LNG supply coming onstream worldwide, which creates a great opportunity for us as a buyer.

We have already taken delivery of 7 LNG cargoes for the UK market, a total of around 230 million therms, and have contracted a further 14 cargoes out to the end of next winter. And from the following winter we get access to additional capacity at Isle of Grain, as we further develop our LNG position and as we continue our discussions with National Oil Companies.

Turning now to power in the UK. As you know we made material improvements to the British Energy deal, recognising the downward shift in the short term commodity market. We have now agreed to take 20% of the equity, along with the right to 20% of the new build opportunity. Alongside this we will also benefit from an 18 Terawatt hour power purchase agreement over a 5 year period starting in 2011. The deal is now being considered by the Office of Fair Trading, and we hope to know more by the end of August.

The nuclear generation takes our peak cover ratio to around 85% and helps diversify our fuel mix away from the heavy gas bias it has today, but also maintains a low-carbon footprint in a world where emissions are likely to become ever more expensive.

Our new-build CCGT power station at Langage in Devon remains on track to be complete by the end of this year. And the wind farms are also performing very strongly, with Lynn and Inner Dowsing contributing significantly to the results in power generation.

And we welcome the UK Government's recent decision to increase the subsidy to 2 ROCs for new offshore wind investment. This improves new-build economics for projects which can get going rapidly. Our 250 megawatt Lincs round 2 wind farm fits into this category, and if we can successfully conclude discussions with contractors and suppliers we expect to make a final investment decision in the next few months.

Turning now to Centrica Storage. It's been another excellent 6 months. The Rough field has had very strong reliability. As you can see from the bold red line on the graph Rough coped extremely well with a very cold start to the year and rapid withdrawals, triggered of course by the Ukranian crisis. The field fell to only 22% full towards the end of February. However, as a result of recent upgrades to the compression facilities, the field was back to over 90% full by the middle of July.

And we are making progress with our new storage projects, where essential works need to be completed as we assess the full project economics. At Caythorpe the detailed engineering has begun and at Bains we have recently been granted planning permission for the onshore terminal.

The economics of new storage projects have been enhanced by the HMRC decision to grant capital allowances for the cushion gas required for such fields. This decision increases the likelihood that these strategically important assets will be built. And we would expect to make final construction decisions on each of these projects in 2010.

Just to turn briefly to Europe. As you are all aware, political progress towards a single deregulated energy market in Europe has been slow and in the key markets the playing field is still tilted in favour of the incumbents. As part of our transaction with EDF on British Energy therefore, we agreed to sell them our 51% stake in SPE, which remains our largest European business by some distance.

We are also announcing today that we will exit our remaining smaller scale activities in The Netherlands and Spain, provided we can do so for value. We will maintain our wholesale supply and trading business in Germany to provide support for our UK supply business. This strategic decision will enable us to focus our capital and management time on the higher return markets with greater growth in the UK and North America.

Looking at North America, the first half result was, as Nick said, disappointing, but we remain confident about the long term potential. The economic and commodity challenges have been even harsher than the UK but we are actually weathering them pretty well.

Downstream, when we strip out the one-offs in Texas, the underlying performance was good. Profitability is up and we have grown our mass markets customer base in the US North East by over 100,000 accounts in the last 12 months alone.

In the C&I business, the integration of Strategic Energy has gone well and we are seeing a real step-up in profitability here, not just in absolute terms but also in terms of the percentage margin.

Upstream the financial performance has been held back by much lower gas and power prices. However operationally again performance has been strong. Our drilling programme and our acquisitions have helped increase our reserves base by over 10% to around 450 bcf equivalent, even after the first half production of 18 bcf.

Looking forward we now have the new management team in place. Chris Weston, who is with us here today, took over the Direct Energy business at the start of July and has joined the Centrica Board.

We are very clear about what needs to be done. We believe that the success in the UK can be replicated in North America.

We are seeking to improve the efficiency of all of the operations here, to expand our presence in our key markets and to support our supply positions with appropriate levels of asset integration to provide robust returns through the commodity cycle.

And we have the skills and capabilities in North America, in retail, in services and, upstream, in gas and power to grow the business and to deliver enhanced returns.

So in summary, once again Centrica did deliver good results against a very challenging economic backdrop. Performance was particularly strong in the UK downstream across the British Gas businesses, where we grew earnings and we grew customer numbers. Bringing together British Gas into a single structure positions it very well for future growth

The improved British Energy deal is a major step forward in strengthening the Group. And with this deal, in exiting SPE, we also position Centrica clearly as a UK and North American Company, two markets which we believe offer strong returns and good value opportunities.

And of course we have a very strong funding position and a wide range of organic opportunities, as the UK and North American governments deal with the dual challenges of security of supply and climate change.

Within our business we have sizeable attractive options in gas development, in new nuclear build, in new gas storage and in renewable generation. And we are also seeking more external investment opportunities becoming available which do fit well within Centrica's growth strategy.

We will of course continue to prioritise our capital where we see the best returns. So Centrica is fundamentally a business which is undergoing a big transition to become better integrated, to reinforce our downstream business, to get back to growth and to continue to deliver the returns and the growth that shareholders have come to expect.

Thank you very much.

End of Presentation