Centrica plc | Annual Report 1997


centrica

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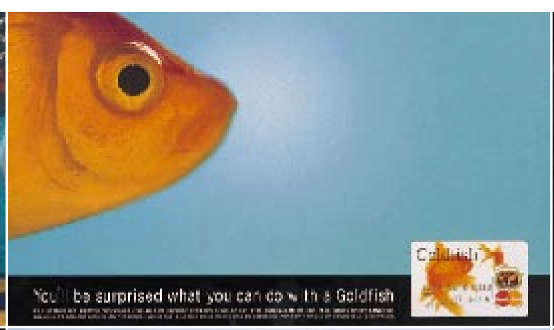
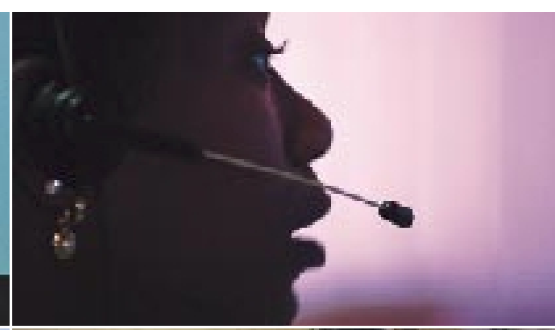
# centrica

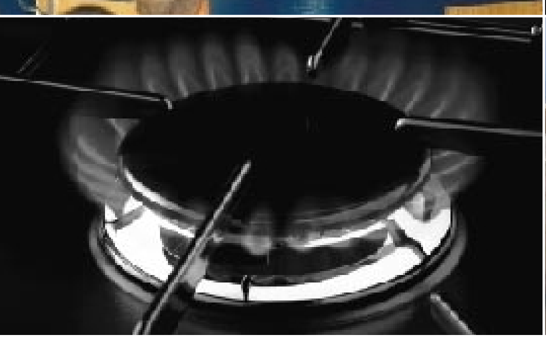
Centrica was formed in February 1997 from the demerger of British Gas plc, and trades as British Gas. The Company's core business is the sale of gas to over 18 million domestic, industrial and commercial customers, which is complemented by a national central heating installation, service and maintenance business and a chain of 240 retail outlets specialising in gas and electric heating and cooking appliances. Centrica also owns two substantial gas fields in Morecambe Bay, operates one of the country's leading gas commodity trading businesses and has growing interests in the financial services sector, including participation in the Goldfish credit card.

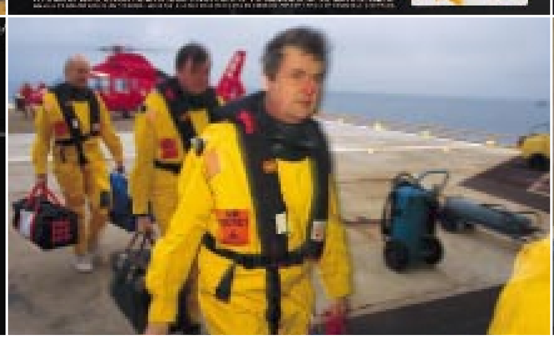
Centrica's aim is to be the first choice supplier of energy and services to homes and businesses.

## the national energy company





Sir Michael Perry

# Chairman's statement

## Our first year

Centrica plc was formed from the demerger of British Gas plc on 17 February 1997. In explaining Centrica's activities I am pleased to be able to highlight the substantial progress we have made as a new company.

This has been a crucial period for Centrica and a testing time for the new management team, particularly in tackling the legacy of our 'Take or Pay' gas supply contracts and customer service systems.

## Serving our customers

Our most important priority is to deliver excellent customer service and we have made significant progress. Our response to customer contacts has improved substantially. We have extended our range of products, services and tariffs, reduced prices and increased customer choice.

## Performance

Although warmer than average weather had an adverse effect on sales for the year, operating profit was up £232 million to £175 million, before exceptional charges of £835 million for gas contract renegotiations, windfall tax and restructuring. Strong cash management generated £877 million, before financing and exceptional payments.

## The Board

Your Board brings together a range of skills and experience with a strong customer focus. Richard Giordano, the main architect of the successful demerger, stepped down on 30 June as Chairman and director. We owe him our thanks.

## Competition

Preparing for the challenge of competition has not been helped by accelerating the gas timetable and delaying competition in electricity supply, both outside our control.

We attach great importance to the roll-out of competition in both gas and electricity being handled in an even-handed way. We continue to be concerned that this should happen within a consistent regulatory framework, so that none of our stakeholders – customers, staff or shareholders – are disadvantaged.

## Dividend

At the time of demerger a number of important uncertainties faced the business, as set out in the Listing Particulars. The Board explained to shareholders that, as a consequence, it would not be possible to reward them by way of a dividend in the short-term. Consistent with this, we are not recommending a dividend for 1997.

We have nevertheless made major strides in addressing these uncertainties. In particular, our inherited gas contract exposure has been reduced to a manageable level. The major remaining uncertainty surrounds the issue of competition, which is unlikely to be fully established nationwide in the gas market until the end of 1998. At that time the Board will review the opportunities for a distribution to shareholders.

Finally, on behalf of the Board, I would like to thank all employees within the Centrica businesses for their considerable commitment and contribution during the challenging first year of operation.

**Sir Michael Perry, CBE**
Chairman

### Key achievements of the year

- higher levels of customer service
- price reductions and new tariffs
- launch of entry into electricity market
- 650,000 Goldfish card holders
- gas supply contracts renegotiated
- new three year price formula agreed with Ofgas
- improved cash flow and operating profit

# Chief Executive's review

## Main achievements

For all parts of the business, 1997 was a very eventful year which has prepared the ground for even greater change in 1998, driven by far reaching reforms in both the domestic gas and electricity markets.

Our aim is to be the customer's first choice for energy and services to homes and businesses. I have set out below our achievements to date in a number of areas which are vital to our business and its future.

## Customer service

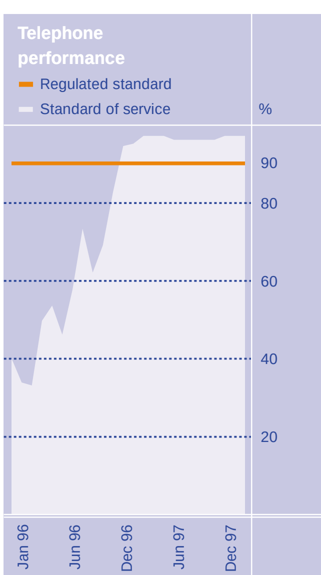
Our main objective remains the provision of excellent service to our customers and we see this as a key component in achieving long-term success.

A Board committee is giving emphasis and direction to all aspects of customer service and all businesses have quality improvement initiatives in place.

Customer panels and regular third party customer satisfaction surveys provide valuable feedback on customer concerns and perceptions.

The benefits of major investment and effort have seen service standards improve during 1997. We have made dramatic improvements in our regulated standards of service for handling customer contact and have also reached our own tougher internal targets. We continue to focus on removing the causes of complaint.

British Gas Trading consistently exceeded the regulated standard for telephone response with over 95% of calls answered within 30 seconds.




## Market share

A key task is to retain significant market share as the gas market is further opened to competition.

In February and March 1997, gas competition was further extended to 1.6 million domestic customers in the South East and South West of England, adding to the 0.5 million customers in the South West of England who had already had access to competing gas suppliers since April 1996. This was followed in November 1997 by the phasing in of competition nationwide, starting with Scotland and the North East of England, which together with the two initial Trial Areas brought competition to over 4.5 million of Britain's 19 million domestic gas customers.

Roy Gardner

Responding to these changes presented very special challenges to the Group, particularly arising from the constraints of the licence conditions imposed on our business. While competitors have priced according to market conditions, we have been prevented from introducing a competitive response (by way of lower prices) during the transition period before competition has been established in an area.

In March 1997, however, we took a number of steps to respond to the increasingly competitive market in the first Trial Area in the South West, including the introduction of a new tariff, ValuePlus. This offered a 12% reduction on the standard tariff and was based on monthly direct debit payments and a one year contract. ValuePlus was endorsed by Ofgas in May 1997 by which time over 50,000 customers had signed up for the new tariff. In September, ValuePlus was also introduced into the second Trial Area in the South East and South West of England.

In a further major initiative in October, we announced our plan to sell electricity to residential customers in 1998 at savings averaging 15% off prices prevailing in November 1997. In conjunction with improved standards of service, these steps enable Centrica to continue to offer a highly attractive energy supply and service package, which is core to our strategy.

## Gas contract portfolio

We set ourselves a further objective to optimise our gas supply portfolio. We inherited a supply situation whereby we were contracted to purchase more gas than we needed and at higher prices than now prevail in the market. A number of substantial contracts were successfully renegotiated in 1997. Exceptional charges of £573 million were borne in 1997 which, combined with £601 million in 1996, brings the total cost of reducing the commitment on 48 billion therms to £1,174 million.

## Gas Levy

As part of the process of reducing the cost of our portfolio we successfully lobbied for the removal of the Gas Levy which applied to certain of our contracted purchases, on the basis that such a levy was no longer appropriate given the changes to the gas market.

## Price revocation

Tax rules prescribed that the valuation of output from the South Morecambe gas field for petroleum revenue tax, royalties and corporation tax was fixed by reference to 1986 prices. Substantial changes in the gas market since 1986 meant that this was no longer realistic. We therefore sought, and have now obtained, the agreement of the Oil Taxation Office to revise the valuation used for tax purposes so that in future it tracks market prices.

At market price levels seen during 1997, our gas portfolio can now effectively be managed as part of the ongoing business.

## Operational performance

We also set ourselves the task of substantially improving our operational performance. A particular feature was the success of British Gas Services in improving operating performance, where a loss before exceptional charges of £196 million in 1996 was reduced to a loss of £49 million in 1997. This business is now well on target to achieve a profit. British Gas Energy Centres traded in challenging market conditions during 1997. In addition, difficulties were experienced in the delivery and installation systems; actions have been taken to rectify the problems. The loss for the year before exceptional charges, was £45 million, compared with £66 million in 1996.

Across the Group as a whole we achieved a 13% reduction in operating costs before exceptional charges compared with 1996.

Improvements in billing systems and in the management of working capital were major factors contributing to a net cash inflow of £877 million before financing and exceptional payments.

## New initiatives

We have been actively developing opportunities to build on our strengths and introduce new products. To this end we have already invested significantly in systems and marketing for our entry into electricity and we have set ourselves the target of gaining around 10% of the domestic electricity market. We are concerned about the delay in the programme for establishing competition in electricity – with market opening now slipping to September 1998 and full market opening not planned until June 1999.

We have also developed our presence in financial services and created a Financial Services Division.

The Goldfish credit card, launched in September 1996 through a joint venture with HFC Bank, continued to grow in popularity and was the fastest growing credit card in the UK in 1997, attracting over 650,000 card holders to date. The Goldfish name has established a firm base on which to build further financial services linked to Centrica's core businesses.

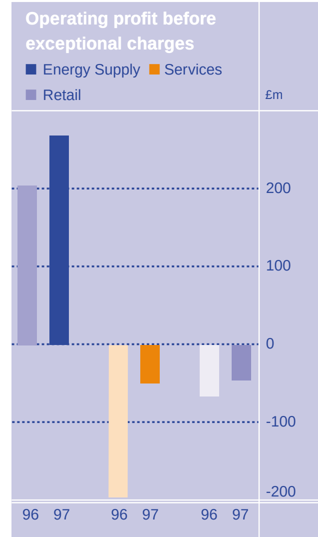
A trial of a home and contents insurance package, in conjunction with Privilege Insurance Company, started in December.

Other initiatives include an extension into home security, providing installation and servicing through British Gas Services.

## The way forward

We will continue to maintain a determined focus on our core business and the objectives outlined above. With the final stage of gas competition now set for May 1998 and the electricity market now due to open up in September of this year, 1998 is a key year for Centrica. I believe we are very well prepared to compete effectively and to meet the challenges ahead.

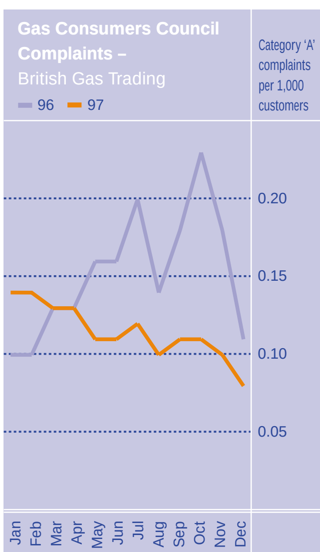
**Roy Gardner**
Chief Executive




Reductions in operating costs contributed to improved operating results in our three business segments.

Price is just one aspect of value, but it's an important one. With across the board price reductions and other initiatives, British Gas customers know they're getting a good deal on gas, and soon on electricity too.

'Warm Duvets', from the national '15%' advertising campaign to announce reductions in British Gas Home Energy prices to millions of customers from January 1998.




For British Gas Trading, the level of category 'A' complaints to the Gas Consumers Council fell by a quarter.

# Business review

## Introduction

The Centrica Group has three main business streams: energy supply and trading, heating installation, service and maintenance, and the retailing of cooking and heating products. In addition we are developing complementary services, including financial services, in conjunction with joint venture partners.

## British Gas Trading

Energy supply to the domestic market, amounting to 71% of turnover in 1997, is carried out under the British Gas Home Energy name in England and Wales and Scottish Gas in Scotland. Sales to industrial and commercial customers are handled by Business Gas, which services the particular needs of our larger customers.

Competitive pressure has increased during 1997, with a number of Regional Electricity Companies and other competitors entering our traditional market. Responding to these pressures we have developed a range of strategies to maintain market share.

Operating costs continue to be reduced by rationalisation of telephone call centres and billing activities, which will lead to greater efficiencies and a concentration of particular skills and knowledge to deal with customer enquiries better.

Investment in systems and communications technology amounted to £104 million, leading to further improvements in standards and response times.

The drive to improve customer service saw dramatic results in 1997. For British Gas Trading the levels of category 'A' complaints to the Gas Consumers Council fell by a quarter. Our speed of response to the 30 million annual telephone calls we receive improved significantly. Customers can now expect their calls to be answered within five seconds on average. The advancements have met with external acknowledgement. British Gas Home Energy gained three ISO 9002 awards for quality and the externally monitored 'Customer Satisfaction Index' places British Gas Home Energy service


**Value initiatives**

- price reductions are enhanced by savings made through direct debit and ValuePlus
- Goldfish points are redeemable against British Gas bills or other home essentials
- service contracts with British Gas Services offer 365-day peace of mind for less than £11 a month

**Top:** British Gas Services is the largest provider of central heating systems in the UK.
**Top right:** British Gas Energy Centres offer value across a range of gas and electric cooking and heating products.
**Above:** The redesigned, customer friendly gas bill has been an award winning success, and has reduced telephone traffic by 14%.

within the 'good to excellent' category. At the recent UK Utility Industries Achievement Awards, British Gas Home Energy gained first prize in the Information Technology category for the development of its new bill. This has been widely acclaimed by customers and has reduced telephone traffic by 14%.

## Domestic market

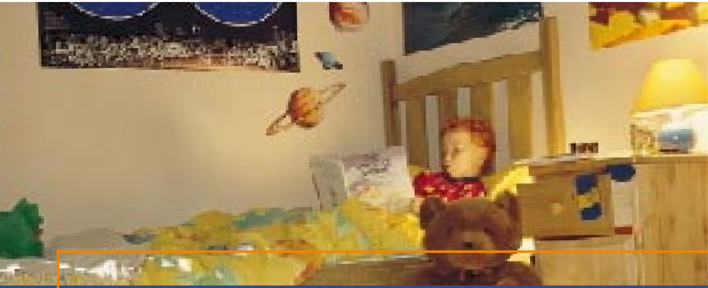
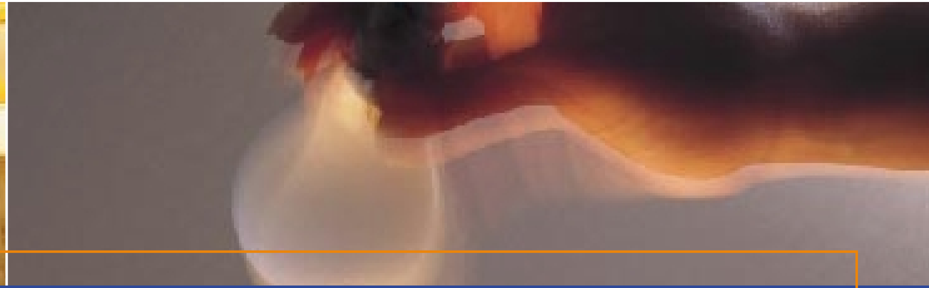
The domestic energy supply business is changing rapidly, with competition in the gas supply market due to be introduced throughout Great Britain by mid 1998: the electricity market is expected to follow suit during 1998 and 1999, later than originally planned. In 1997 we positioned ourselves to provide a total energy package offering the best value for money – by a combination of fair prices, excellent service and unrivalled experience.

As a result of savings made through improved efficiencies, the renegotiation of gas contracts and further reductions in transportation costs, new price reductions for British Gas Home Energy customers came into effect in early 1998. With a saving of around 15% for switching from payment by cash or cheque after 10 days to monthly direct debit payment, or a £30 reduction when all four quarterly bills are paid promptly, there are significant savings compared with 1997, when the equivalent savings were 6% and £8 respectively. Furthermore, prices to prepayment customers have been reduced by around 4% in February 1998.

These savings, together with our new capability in electricity supply and our growing range of financial services, enable us to offer a very attractive package of energy and services in the highly competitive environment which will emerge in the next year and beyond.

Although the effect of competition on the Group will be far-reaching, we are committed to ensuring a smooth transitional period for customers. The introduction of competition has given rise to concerns about how some new market entrants are approaching gas customers. The door-to-door sales and high-pressure selling techniques have resulted in some customers being confused and transferred to other suppliers without their knowledge.

The British Gas Rugby League Test Series between Great Britain and Australia, linking the British Gas brand with a major national event.

Our aim is to be the first choice supplier of energy as competition extends across Britain, we never forget that our customers are our future.


On 29 October 1997, British Gas announced its intention to compete in the electricity market nationally. We are positioning ourselves to provide a total energy package offering the best value for money.

Customer panels are valued by the Company and provide feedback on existing and proposed products and tariffs and on levels of customer service.

Centrica has joined other companies and organisations involved in the domestic energy supply business to support various initiatives to implement agreed codes of practice to protect the consumer and ensure that the business is conducted fairly. In October, Ofgas introduced proposals for a new licence condition, applicable to all suppliers, enabling Ofgas to monitor, control and take action against suppliers not complying with the new requirements of the licence. This takes effect from February 1998.

Despite the discounts offered by new suppliers, substantial resources directed into their marketing campaigns, together with the licence constraints on British Gas' ability to compete, we have retained over 75% of customers in areas where competition was introduced prior to April 1997.

The final phase of competition, set to include the whole country by May 1998 commenced in November 1997. Competition had been introduced in the South West, the South East, the North East and the North West of England and Scotland by the end of February 1998.

By the end of February 1998, about 990,000 customers had transferred from British Gas to other suppliers, but significant numbers of customers are also returning to British Gas. Over 82,000 customers in the competition areas have already returned, or as new householders have chosen British Gas as their supplier, since competition began.

### Electricity

By the end of the year preparations at Centrica were well advanced to compete in the electricity market. In January 1998, however, the Director General of Electricity Supply announced a further delay of five months in opening up the market for domestic electricity supply. Since this timetable is substantially behind the gas market, it is very important to our commercial interests that the timetable is not further delayed by the electricity industry, as the divergence of timetables creates a major distortion in the gas and electricity markets. While the Public



In 1997 Goldfish was the fastest growing credit card in the UK with over 650,000 cards in issue. Goldfish points are redeemable against British Gas bills, BT and TV Licensing, as well as at Boots, Asda and Marks & Spencer.

**Market potential**

- we currently serve over 18 million customers
- the energy market is opening to full competition
- we will continue to grow by offering new payment options, home based service packages, financial services and 'dual fuel'

Electricity Supplier (PES) companies continue to enjoy their monopoly in electricity they also benefit from the earlier opening of the gas market. Ofgas and Offer have sought undertakings from the companies concerned to help mitigate some of the market distortions which they have identified. We have invested significantly in preparations to sell electricity with systems prepared and marketing activities well advanced.

Electricity will be offered by British Gas at preferential rates to customers who also take gas, offering a 'one stop shop' in domestic energy needs. Customers who choose British Gas for their electricity supply alone will still benefit from savings but to a lesser extent than those taking a combined gas and electricity package.

### LP Gas

The number of British Gas customers beyond the gas mains continued to grow significantly and we have made major gains in the supply of liquified petroleum gas to domestic and business customers.

### Business Gas

In addition to domestic gas supply, we also supply gas to customers in the industrial and commercial market through our Business Gas brand. This market has been fully competitive since 1992 and British Gas has a market share of about 24%.

Profitability has been markedly affected by the inherited long-term gas purchase contracts. Actions to reduce our exposure to above market gas prices are discussed below under 'Take or Pay' contracts.

During 1997, the loss in this market was £323 million, an improvement of £44 million compared with 1996. This was achieved through improved prices offset in part by higher gas costs.

### Energy management

The efficient management of the Company's portfolio of gas and, shortly, electricity purchase contracts, and the Morecambe reservoirs, is central to the efficient sourcing of our customers' energy demands. This function is carried out by Centrica's Energy Management Group.

We made over 80,000 gas deliveries last year to our customers outside the mains gas supply area.


**From our unique capacity to meet demand peaks, to our well established trading operations, Centrica's all-round expertise in the supply of gas and related services is unrivalled.**

A new team arrives for their shift at Morecambe, where safety and efficiency are a priority.

Accord Energy has a proven record in gas trading and energy risk management.

British Gas Energy Centres is a leading retailer for cooking and heating products through 240 shops nationwide.

## Wholesale market

As a result of the deregulation of the UK gas supply business there have been widespread changes in the way in which gas is bought, transported, traded and sold to end-users in both the commercial and domestic markets.

In order to take advantage of the opportunities that these changes allowed, in 1994 BG plc (formerly known as British Gas plc) entered into a joint venture, known as Accord Energy, with Natural Gas Clearinghouse, a US gas trading company.

Accord Energy established itself as the market leader in short-term gas trading and wholesaling and has since developed a strong track record in trading and energy risk management – skills which are increasingly important to the Group.

Following demerger, Centrica agreed terms with Natural Gas Clearinghouse to assume operational control of Accord Energy.

Accord Energy trades with all the major participants in the wholesale energy market. In addition, it now applies its management expertise to British Gas' substantial portfolio of gas purchase contracts.

## Continental sales

The wholesale gas market has broadened in scope as a result of the planned Interconnector pipeline connecting the UK's high pressure transmission system with Continental Europe, due to be completed in Autumn 1998. Centrica has been actively developing sales opportunities on the Continent, and during 1997 concluded three major deals with buyers in Germany and the Netherlands which amounted to some 166 billion cubic feet of gas per annum.

The skills developed by Centrica and Accord Energy over the last few years will provide an excellent basis for an expanded role in Europe as the market develops.

## Sources of gas

Gas supplies are sourced from a portfolio of long-term third party contracts, production from the Group's own fields in Morecambe Bay, and from short-term trades in the wholesale

The Morecambe gas fields are capable of producing up to 20% of Centrica's annual gas requirements.

### The benefits of experience

- our unique Morecambe facilities enable us to meet our customers' demands for gas on the coldest days of the year
- our trading activities include both gas and electricity
- we have a national gas service organisation, including full parts back-up

A digital mobile communications network enables service engineers to prioritise work and order parts quickly and efficiently to meet customer needs.

market. Some gas is also held in third party storage until required at times of peak demand.

## Morecambe gas fields

The Morecambe gas fields, Centrica's major asset, are owned by its subsidiary, Hydrocarbon Resources Ltd (HRL). North and South Morecambe represent the largest producing gas fields in the UK Continental Shelf, with proven and probable reserves of approximately 3,692 billion cubic feet (as at January 1998).

The Morecambe fields are capable of producing up to 20% of Centrica's annual gas requirements. The unique capabilities of the reservoirs and production plant mean that Morecambe also has a key role in producing gas at short notice when peaks occur in UK demand. The field can supply as much as 15% of UK peak demand, giving Morecambe production an additional role to play in balancing supply and demand.

The reservoirs have been re-mapped using data from the latest three-dimensional surveys. Initial indications from these surveys show that the volumes of gas in place are similar to previous estimates.

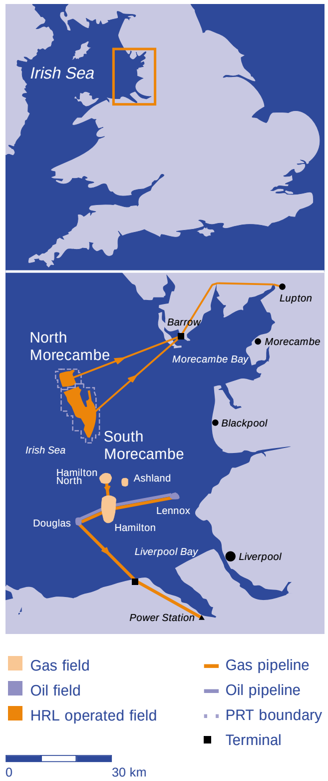
Additional perforations were added in five wells in the South Morecambe field to increase well deliverability. Plans are in place to drill two additional wells in South Morecambe during 1998, and to re-perforate a further eight wells.

The three-yearly updates of the safety cases required by legislation for major hazard installations have been developed and submitted to the Health and Safety Executive. These demonstrate that all major hazards have been identified, their risks evaluated, and that effective management processes and procedures are in place to control them.

## British Gas Services

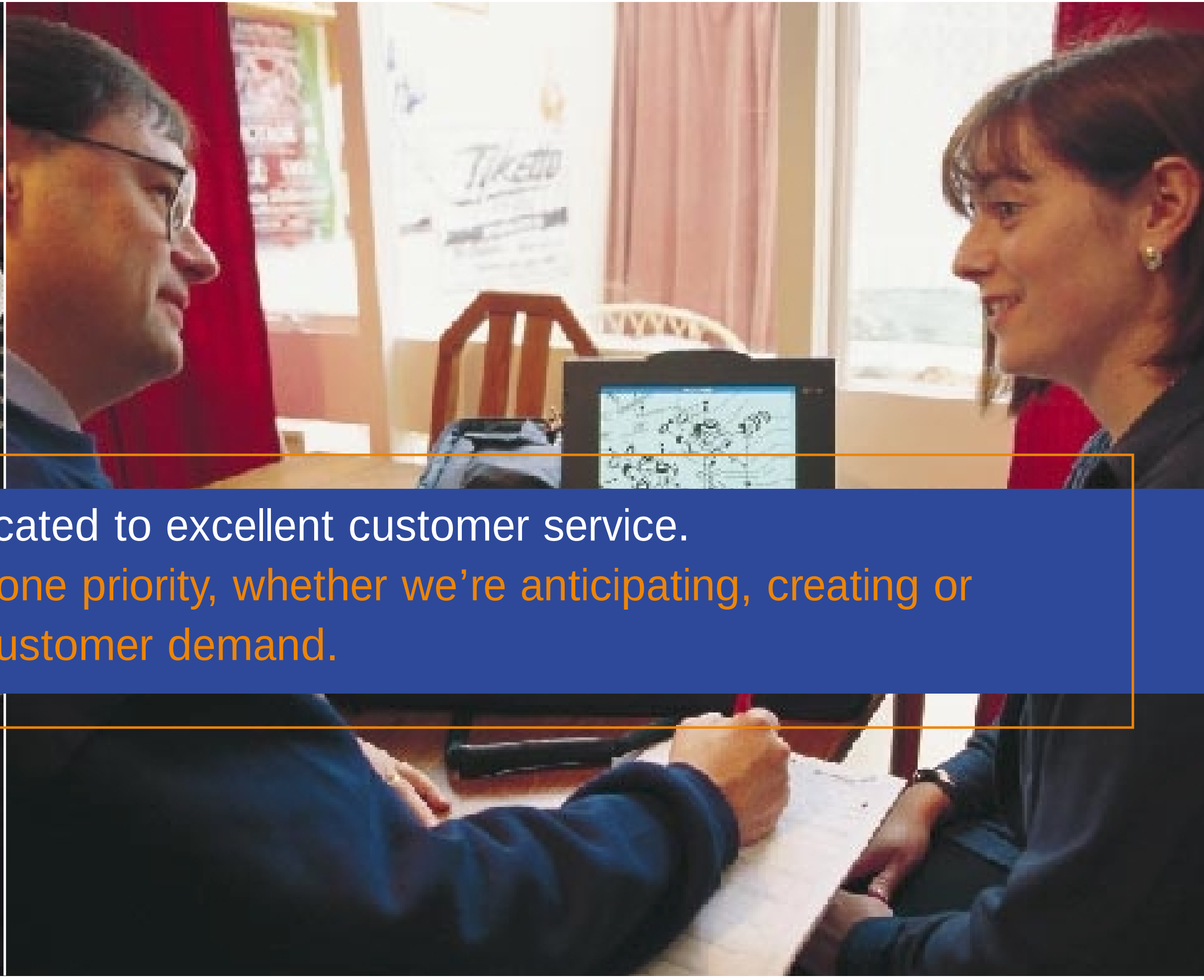
British Gas Services is the leading company in the installation, service and maintenance of domestic central heating systems and other gas heating appliances. The product range is being extended into home security and air-conditioning products.

### Morecambe gas fields



## Centrica is dedicated to excellent customer service. It's our number one priority, whether we're anticipating, creating or responding to customer demand.

Roadshows around the country provide customers with information about new tariffs, products and services.



Service engineers are able to provide an immediate quotation in the customer's home for improvements to an existing central heating system or for the cost of spare parts.

AccuRead, a joint venture with Group 4, provides meter reading services to British Gas and other clients.

Major steps were taken in 1997 to invest in improved customer service, operational efficiency and improve profitability within this business, which resulted in a major improvement in performance.

The operating result before exceptional charges was a loss of £49 million in 1997, compared with a loss of £196 million in 1996. This improvement of £147 million resulted directly from reductions in the cost base of the business, improving the trading margin and productivity.

Our 5,000 engineers now work from home rather than a local depot and we have invested significantly in technology to support their operation.

Service engineers are now equipped with laptop computers connected via mobile phones and the GSM public digital communications network to an automated work management system. In addition to fault diagnosis, these optimise work allocation, assist with urgent customer demands and order spare parts from the central warehouse for delivery the following day.

British Gas Services broadened its range of services provided during the year, including the following initiatives:

- the introduction of our own brand range of boilers and central heating appliances, to supplement our range of heating products;
- the national phased launch of home security after a successful pilot study;
- the re-launch of an installation and maintenance service for gas cookers;
- the extension of on-demand services to include gas safety inspections, breakdowns and servicing of cookers; and
- installation of carbon monoxide detectors.

For British Gas Services, customer service standards improved during the year. Customer satisfaction levels also improved and category 'A' complaints to the Gas Consumers Council were down by 39%.

Around seven million jobs were undertaken by service engineers during the


**Above:** Help is on hand from experienced staff for customers needing advice on their purchases in our British Gas Energy Centres. **Top right:** Service engineers undertook around 7 million jobs nationwide during the year.

### Service initiatives

- demerger has allowed Centrica to focus on maintaining high service standards in core markets
- a long-term commitment to service drives all our activities
- electricity will follow similar exacting standards of customer service

year, with over 84% of servicing work being completed on the first visit. In addition to the National Parts Centre receiving an ISO 9002 award, the Stockport Area Service Centre gained an ISO 9001 award in recognition of the quality management system employed in its operation.

The radical changes undergone by the Services business during 1997 were supported by a major internal communication exercise, ‘Breakthrough ’97’. The programme involved all 5,000 engineers and management exchanging ideas on delivering service excellence to customers.

Recognising the skill base and infrastructure available through British Gas Services, the Company undertook a trial in the first half of 1997 to offer home security products to domestic customers in the North of England. This product is being extended to the rest of the UK during 1998.

Similarly, air-conditioning products are being offered in the South East of England, in response to market demand.

## British Gas Energy Centres

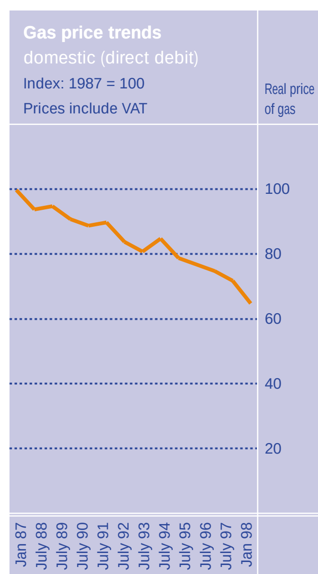
British Gas Energy Centres is the leading high street retailer for gas cookers and fires, with a national network of 240 shops offering a comprehensive range of gas and electric cooking and heating products. During 1997, the electrical product range has been extended in about half our shops to include refrigerators, washing machines, dishwashers, vacuum cleaners and small electrical products such as kettles and irons.

Two new shops were opened in Edinburgh and Kilburn – with encouraging trading results to date. Three loss-making shops have been closed.

Considerable investment has been made during 1997 in systems development to support and enhance operations.

Sales for the year at £183 million were up 5% on the previous year. The loss for the year before exceptional charges at £45 million showed a £21 million improvement against 1996. Satisfactory progress was also made in reducing operating costs during the year.

The last quarter saw disappointing sales




Gas prices have fallen steadily, with the competitive market continuing to bring better value to customers.


For British Gas Services, category 'A' complaints to the Gas Consumers Council were down by 39% to less than one per thousand jobs.

of gas fires and problems with delivery and installation; however the latter problems had been overcome by the end of the year, and steps have been taken to improve performance and reduce losses during 1998.

Initiatives include strengthening the management team to provide greater focus and expertise in the retail sector, and a review of the product range and the portfolio of shops.

A programme of rebranding the shops as British Gas Energy Centres is gathering momentum. This will reinforce the extension of our product range and enhanced customer service, with the aim of improving the profitability of our retail operations.

## Financial Services

To complement the energy supply, service and retail operations offered to households in Great Britain under the British Gas brand, a major element of the Company's strategy has been a move into financial services and direct response in 1997. Our objective is to develop new business using our core skills and existing products and services.

Foremost among these is the Goldfish credit card, giving money off home-related products and services through the collection of points. Launched in September 1996, this is a joint venture with HFC Bank, although rights to the Goldfish name remain with Centrica. The card was launched with British Gas as the first redemption partner for Goldfish points, allowing card holders up to £75 off their annual gas bill.

This was followed by other partners, including Boots, Asda, BT, TV Licensing and Marks & Spencer.

The Goldfish brand is now well established in the financial services sector and over 650,000 cards have now been issued. This venture has made an excellent start in this sector, establishing a new brand name for the Centrica Group that complements and builds upon the well-established British Gas brand.

This year we took the first steps to extend our financial services products through a trial of a home and contents insurance package. This is in conjunction with Privilege Insurance Company, who manage the underwriting risks.

A further initiative under the Goldfish brand is the Goldfish Guide. This is a new concept for the UK where customers phone for a comprehensive, independently prepared buying guide concentrating mainly on high value consumer goods. The Company, in conjunction with our Goldfish credit card partner, HFC Bank, is also launching personal loans under the Goldfish brand.

## Other joint ventures

We have equity interests in AccuRead, a joint venture with Group 4, which provides meter reading activities to British Gas and other clients, and AG Solutions, an information systems joint venture with Amdahl.

Both ventures performed well and made a positive contribution to profits. AccuRead has significantly reduced British Gas' meter reading costs, whilst improving meter reading performance well in excess of its initial business targets.

## Business environment

Centrica operates within a complex set of regulatory, financial and tax constraints, arising both from the regulation of its businesses and from its former monopoly position as part of BG plc (formerly known as British Gas plc).

### Regulation

British Gas Trading is subject to regulatory constraints which influence the management and performance of the business, particularly in the domestic gas market.

In developing a strategy to deal with the competitive domestic energy supply market, the regulatory position needs to be fully understood and effectively managed.

Our main regulatory influences arise from the licence conditions which govern our status as a gas supplier and shipper, and arrangements governing the transportation and storage of gas within Transco's system. In addition, as we enter the electricity market we will be governed by our Second Tier Electricity Supply Licence conditions.

As part of the special arrangements which apply to British Gas Trading alone, Ofgas imposes certain price restraints on British Gas' national regulated tariffs for gas supply, affecting both the daily standing charge and the price paid for gas used. These restraints take the form of a maximum price cap on each of the four national regulated tariffs which are based on a range of payment methods.

In March last year, the price control formula which had been in operation since 1992 came to an end. Discussions with Ofgas on the new formula, which will have effect until 31 March 2000, gathered momentum during the first part of 1997, and concluded with formal approval of the new price controls in June 1997.

Key aspects of the allowable cost base in the formula are an RPI-4 element of supply costs; pass through of gas costs, transportation and storage, subject to an economic purchasing requirement as appropriate; and an allowance of £120 million of costs unrecovered under the previous price control formula. The formula also allows a profit margin of 1.5% of turnover.

Throughout 1997 the Company has been in discussions with the Data Protection Registrar (DPR) concerning the use of its gas supply database for non-gas supply related business. Although British Gas Trading has provided its customers with the opportunity to opt out of further uses of the data, the DPR is seeking an alternative approach and has issued and served an Enforcement Notice against British Gas Trading. British Gas Trading appealed against the Enforcement Notice and the Data Protection Tribunal heard the appeal in February 1998. The decision of the Tribunal is awaited.

The Government is currently undertaking a review of utility regulation and will be issuing a Green Paper early in 1998. Proposals to merge Ofgas and Offer and to place greater emphasis on social and environmental aspects of regulation would affect Centrica, if included. The Company is taking the lead on the issues of prepayment and fuel poverty to help address what is an industry problem and to bring the benefits of competition to customers in these groups.

### ‘Take or Pay’ contracts

The efficient management of the Company’s gas contract portfolio received a substantial boost in 1997 through further renegotiation of the high-priced, fixed-volume ‘Take or Pay’ gas contracts.

In July further gas contract renegotiations were announced with Amerada Hess, Enterprise Oil and OMV. This involved a cancellation of further volumes from the Beryl field, which was the subject of a larger transaction with Mobil in 1996.

Mobil, along with Arco and Eastern Natural Gas, were also party to a further cancellation of volumes from the Welland field, which was agreed in September.

In December two substantial price renegotiations were agreed with Conoco, Elf and Total, followed by other smaller deals with Chevron, Phillips Petroleum, Agip and Fina. These agreements, together with the renegotiations with BP and Mobil concluded in 1996 and the smaller transactions concluded in 1997 will reduce Centrica’s weighted average cost of gas from October 1998.

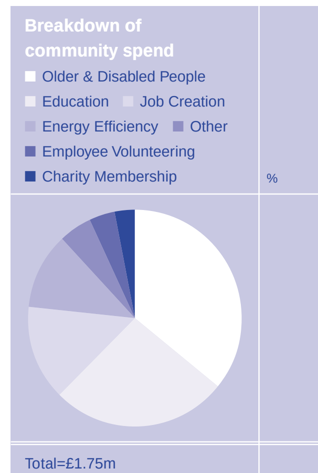
### Price revocation

Having renegotiated a number of its third party gas contracts, Centrica sought in 1997 to adopt a new, market-based price for the contract governing sales of gas from the South Morecambe field. Adoption of a lower price is essential to the efficient management of Centrica’s tax burden. In February 1998, the Oil Taxation Office confirmed that such a price revocation was acceptable. The valuation of gas will in future track market prices. This affects charges for royalties and corporation tax from 1998 onwards and the provision for petroleum revenue tax (net of deferred corporation tax) from 1997 onwards.

### Gas Levy

A helpful development for Centrica in 1997 was the Government’s decision in the July budget to cut the rate of Gas Levy on older gas fields to zero with full effect from April 1998. This tax added substantially to Centrica’s third-party gas costs, and led to a price distortion no longer compatible with the free trade in gas.

Last year the Centrica Group contributed £1.75 million to a range of projects throughout England, Scotland and Wales.



Our reputation as a caring company, responsive to community needs, helps us to maintain the respect and trust of our customers in an increasingly competitive environment.

A British Gas Services apprentice gaining experience; one of 50 recent recruits.

The GasCare scheme aims to provide high standards of care for elderly, disabled and chronically sick customers, one example of which is the provision of Braille bills.

The British Gas Handyperson scheme, working with Age Concern, provides volunteers to help older people carry out odd jobs and maintain their independence.

## Centrica and the community

Centrica recognises that its commercial success depends on the well-being of the communities it serves. As the country's largest supplier of energy to the home, we play a vital role in shaping the quality of life of 18 million households.

We are particularly conscious of our responsibilities to older customers and those with special needs. The GasCare scheme last year gave over a million older or disabled customers the opportunity to have free gas safety checks, while the Password scheme gives vulnerable customers freedom from fear of bogus callers. Our Language Line service helps customers whose first language is not English.

Working in partnership with Neighbourhood Energy Action and Energy Action Scotland, Centrica supports campaigns to promote energy efficiency and the take-up of grants, especially in low income households.

## Health, safety and the environment

The Centrica Group is committed to high standards of health, safety and environmental conduct. Since demerger, the Group continues to build on the commendable performance record of British Gas and has laid the foundations for a Health, Safety and Environmental Management System, based on industry best practice, to be introduced in 1998.

Centrica participated in the demanding 1997 Environmental Engagement Survey of the FTSE 100 companies conducted by Business in the Community, and was well placed in the second quintile.

With respect to external developments, global warming is still high on the political agenda, with the EU and particularly the UK aiming for ambitious reductions in carbon dioxide emissions by the period 2008-2012. Natural gas will have a vital role to play in meeting these targets, as it produces significantly less carbon dioxide than rival fuels.

Natural gas could be of enormous benefit in improving air quality in the key area of


Refuse collection, with one of Merton Council's fleet of natural gas vehicles.

**Centrica supports community projects which**

- provide practical assistance to older and disabled people
- encourage young recruits through training schemes
- encourage staff to help their communities
- promote the efficient use of our energy products
- educate young people about responsible use of our products and services


The Scottish Gas Education display at the 1997 Royal Highland Show in Edinburgh.

road transportation and British Gas NGV, our natural gas vehicle business, continues to pioneer developments in this important area. Over 80 commercial fleets now operate vehicles on natural gas, including the Government's own car service. NGVs, often much quieter and cleaner than the vehicles they replace, are popular for use as buses and refuse trucks. British Gas NGV is also the UK's leading supplier of compressed natural gas for use in vehicles, via a network of gas stations.

## Community involvement

Last year the Centrica Group contributed £1.75 million to a range of projects throughout England, Scotland and Wales. Over £500,000 of this was given to local community projects, including:

### Powersavers

This innovative energy-efficiency competition and teaching programme for primary and secondary schools is operated in partnership with the Department of the Environment, Transport and the Regions and the Energy Savings Trust.

### Disability in Business

Last year this helpline, based in one of our call-centres and operated by visually-impaired volunteers, advised over 2,000 small and medium sized businesses on how to respond to the needs of disabled staff and customers.

### Scottish Gas Youth Challenge

An award-winning project run jointly with the East End Partnership in Glasgow, the Challenge provided personal development programmes for young people in an area of acute urban deprivation.

### Carers National Association (CNA)

Centrica is helping to fund the CNA's national helpline for carers, and Roy Gardner was recently elected President of the association. The Company is also exploring ways in which it can respond to the needs of staff who are carers.

David Bellamy launches the 'Powersavers' energy-efficiency teaching programme for primary and secondary schools, a partnership between Centrica and the Department of the Environment, Transport and the Regions and the Energy Savings Trust.

# Financial review

## Financial highlights

| | 1997 £m | 1996 £m |
|---|---|---|
| **Results for the year ended 31 December** | | |
| Operating profit/(loss) before exceptional charges | **175** | (57) |
| Earnings/(loss) before exceptional charges | **44** | (203) |
| Loss after exceptional charges | **(791)** | (1 060) |
| Group cash flow before use of liquid resources, financing and exceptional payments | **877** | (2) |
| Group cash flow after use of liquid resources, financing and exceptional payments | **2** | 12 |
| **Position as at 31 December** | | |
| Debt, cash and money market investments | **41** | (178) |
| Market capitalisation | **4 004** | not applicable |

The Group came into existence when it was demerged from BG plc (formerly known as British Gas plc) on 17 February 1997. The financial statements have been prepared using merger accounting principles as if the Group had been in existence throughout the whole of both the current and the preceding years.

### Profit and loss

#### Turnover

Turnover at £7,842 million was £283 million lower than in 1996. The adverse effect of weather, year on year, was estimated as £462 million, with 1997 being substantially warmer than average and 1996 being colder than average. The consolidation of our Accord Energy subsidiary from March 1997 added £459 million to turnover. The impact of competition in the domestic market in 1997 reduced turnover by an estimated £106 million.

The volume of gas sold by the Group, with the exclusion of commodity market trades, fell from 19,173 million therms in 1996 to 17,028 million therms in 1997. Of these volume reductions just over 1.1 billion therms related to the warmer weather.

#### Cost of sales

Gas and transportation costs are the main elements making up cost of sales.

The average unit cost of gas purchases varies year on year because of contractual price escalators and as a result of changes in the mix of fields from which gas is purchased. For both 1997 and 1996 the average unit cost of gas externally purchased to satisfy the demands of the domestic, industrial and commercial markets was 19p.

The Group sourced 3,199 million therms of gas (1996 3,409 million therms) representing 19% (1996 18%) of its requirements for the domestic, industrial and commercial markets from its wholly-owned Morecambe gas fields. The balance was mainly purchased under long-term gas purchase contracts from third party producers.

Unit transportation costs for the first nine months of 1997 were higher than those in the previous year due to two price increases during 1996. The average price reduction of 13% from October 1997 however, brought the average unit transportation cost for the year as a whole back to a similar level to that incurred in 1996.

The valuation, for petroleum revenue tax (PRT), royalty and corporation tax purposes, of the gas output from North and South Morecambe is governed by a 'tax price' agreed with the Oil Taxation Office. The substantial changes in the gas market since the original tax price for South Morecambe was agreed in 1986, including the fall in gas prices, meant that the previously agreed South Morecambe tax price was no longer realistic. Agreement has now been reached with the Oil Taxation Office that the value for tax purposes of output from South Morecambe will, from 1 January 1998, track market prices. Due to the prospective method of accounting for PRT there was a net beneficial impact in 1997 of £72 million, comprising a reduction in the PRT charge of £105 million and an increase in deferred corporation tax of £33 million. The impact for 1998 and subsequent years will be delivered through reductions in PRT, royalties and ring fence corporation tax.

#### Operating costs

Group operating costs before exceptional charges at £1,036 million were £150 million lower than in 1996. Manpower reductions were a significant factor with the average full-time equivalent level of employees down by 21%.

#### Operating profit before exceptional charges

Operating profit before exceptional charges at £175 million was £232 million better than 1996. The analysis of the operating profit before exceptional charges shows improvements in all segments.

Energy Supply improved by £64 million despite the impact of the warmer weather, estimated as £105 million. This was more than offset by £47 million of lower operating costs, the reduction in PRT of

£100 million and profits of Accord Energy of £16 million from March 1997 when it became a subsidiary.

In Services, higher turnover, improved margins and lower operating costs all contributed to a substantially reduced operating loss of £49 million against the 1996 loss of £196 million. The loss in the second half fell to £19 million against £30 million in the first half, reflecting the continuous improvements being made.

The operating loss of £45 million from retail operations was £21 million better than in 1996. The improvement came mainly from operating cost reductions whilst turnover growth at 5% was disappointing. Operational problems with delivery and installation resources depressed the fourth quarter turnover and margins.

### Exceptional charges

Exceptional charges in 1997 of £835 million (1996 £822 million) consisted of four elements:

- Gas contract renegotiation costs charged in 1997 of £573 million were in addition to the £601 million charged in 1996. In total these renegotiations have enabled us to reduce our volume commitments by 26 billion therms and reduce prices on a further 22 billion therms;
- Sales contract loss provision charges were £35 million (1996 £104 million);
- The Government, in its July budget, imposed a windfall tax on Utilities, with Centrica having to bear £192 million. As this was not a tax on current profits, it has been included within operating costs as an exceptional charge; and
- Restructuring costs of £35 million were incurred during the year principally within the Services business. In 1996 the equivalent charge to the Group was £117 million.

### Interest

Net interest receivable at £39 million was at the same level as in 1996. The main components of net interest arose on transportation prepayments, short-term investments and debt, and finance leases. Interest also included notional charges on the unwinding of discounted net present value liabilities.

### Taxation

The tax charge on the results for the year of £168 million (1996 £235 million) primarily related to profits arising from the Group's gas production activities, which are not capable of being group relieved by tax losses arising elsewhere in the Group. It was £67 million less than in 1996 mainly due to the reduction in the rate of corporation tax and higher deferred tax charges offset by group relief in 1996, which arose as a consequence of the demerger.

### Earnings

The underlying earnings of the Group before exceptional charges were £44 million compared to a loss of £203 million in 1996. After exceptional charges the loss for the year was £791 million (1996 loss of £1,060 million).

### Year 2000 and Euro costs

During 1997 £3 million was incurred on preparations for Year 2000 computer compliance. It is estimated that approximately £43 million will need to be incurred in 1998 with a further £15 million in 1999.

Preparations for Euro compliance are at an early stage. Costs incurred to date have been negligible and it is too early to estimate future compliance costs.

## Cash flow

### Net cash flow

Net cash inflow of £877 million before financing and exceptional payments was £879 million higher than the outflow of £2 million in 1996, as a result of improvements in underlying profit and reductions in working capital levels. The reductions in working capital resulted from improvements in the performance of our billing systems and improvements in cash management generally. Weather also had a favourable impact on cash flow in 1997, as we received higher customer receipts from the colder last quarter of 1996, and our outgoings in the warmer last quarter of 1997 for gas and transportation were lower.

It is estimated that the combination of weather patterns in 1996 and 1997 had a beneficial effect in the order of £150 million on cash flows in 1997. A proportion of this benefit is likely to reverse in 1998.

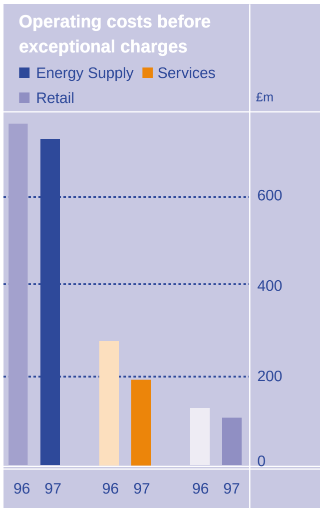
During the year cash outflows in respect of exceptional payments amounted to £653 million, including £464 million relating to the renegotiation of long-term gas contracts and £96 million for the first instalment of windfall tax.

### Debt and investments

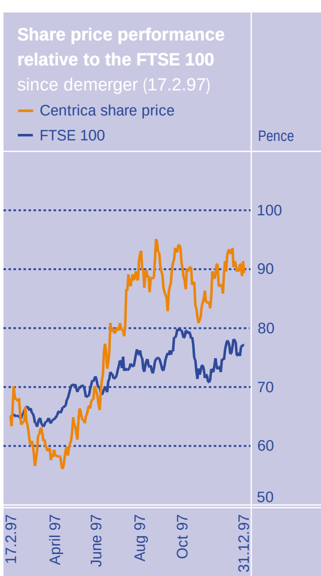
Despite the high level of cash outflow for exceptional payments, the underlying strength of cash generation resulted in the Group moving from a net debt position of £178 million at 31 December 1996 to a net investment position of £41 million at the end of 1997.

### Group facilities

The Group's net debt position at 1 January 1997 of £178 million and all subsequent debt up to demerger was funded primarily by BG plc. At the time of demerger on 17 February, the debt level of £505 million was close to its seasonal peak and was repaid to








BG plc by drawing down on the Group's uncommitted facilities, which had been negotiated prior to demerger.

In addition to uncommitted facilities, a three and a half year committed £1,000 million revolving credit facility was arranged in December 1996.

## Assets and liabilities

### Fixed assets

The most significant component of tangible fixed assets is Centrica's Morecambe gas fields which had a net book value of £1,480 million as at December 1997 (1996 £1,646 million). This asset value represents the cost of constructing the production facilities net of depreciation to date. The remaining proved gas reserves in the fields, estimated at 3,226 billion cubic feet (bcf) (1996 3,547 bcf), have substantial value but are not included on the balance sheet.

### Current assets

A large proportion of the stock balance represented gas held in storage to meet exceptionally high peak demand. As part of the strategy for meeting these requirements, the level of gas stocks was increased to £120 million at the end of December 1997, compared with £70 million in 1996.

Due to the impact of the different weather patterns at the end of 1996 and during 1997 and the improvements in our billing processes, gas sales debtors reduced substantially during the year from £1,637 million in 1996 to £1,200 million in 1997.

Transportation costs are paid a month in advance; prepaid transportation at the end of December 1997 was £271 million (1996 £354 million).

Debtors include 'Take or Pay' prepayments of £309 million (1996 £511 million) as a result of gas purchase commitments exceeding sales volumes in previous years. In 1997 44% of the volume paid for but not delivered in previous years was sold. It is anticipated that the prepayment will continue to be converted into cash in forthcoming periods.

### Creditors and provisions

The increase of £171 million in accruals and deferred income included contract renegotiation accruals of £76 million, and £24 million within Accord Energy Limited, which was consolidated for the first time in 1997. Creditors falling due after one year included £70 million of deferred consideration in connection with the change in investment in Accord Energy Limited.

The main elements of provisions comprised deferred PRT, long-term contract losses and renegotiation costs, Morecambe gas field abandonment and deferred corporation tax. The deferred corporation tax balance reduced by £40 million during 1997 as a result of the reduction in the rate of corporation tax to 31% and the reversal of timing differences.

### Shareholders' funds and market capitalisation

Net assets of the Group, as represented by shareholders' funds, fell during the year from £2,187 million to £1,311 million, mainly as a consequence of exceptional charges incurred.

The Company's mid market share price at the close of its first day of trading on 17 February was 64.25p per share. The lowest price during the year was 56.25p on 29 April 1997 which coincided with the end of free trading for small investors.

The highest price during the year was 95.25p on 2 September 1997 and the mid market closing price on 31 December 1997 was 90.25p, providing a market capitalisation for the Company of £4,004 million.

### Treasury policy

Group Treasury operations are managed centrally by a small, specialised team operating within a formal set of treasury policies and objectives approved by the Board. The Treasury team operate as a cost centre and pursue a risk averse philosophy in the performance of their objectives. No transactions of a speculative nature are undertaken.

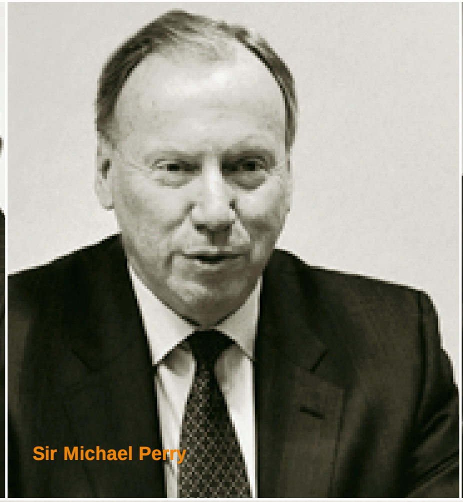
The primary objective is to arrange cost-effective funding and manage cash flow efficiently. In addition the Treasury team manage the financial risks arising from funding and investment activities and other financial risks associated with business operations. These financial risks are explained below:

- Foreign exchange risk arises from the exposure within long-term gas purchase contracts to movements in oil prices and hence to the US Dollar/Sterling exchange rate. This is managed by the purchase of a portfolio of forward exchange contracts which effectively reduce the exposure over future periods on a reducing basis. Other foreign exchange exposures which may occur within normal business are hedged once they become certain;
- Interest rate exposure arises from the Group's seasonal cash flow. Surplus cash is invested in short-term instruments in accordance with Board policy. The seasonal cash flow acts in part as a self hedge against long-term movements in interest rates. Short-term interest rate risk is managed by the purchase/sale of forward rate agreements to hedge in part against adverse movements in short-term sterling market interest rates; and
- Since demerger the risk of consequential losses arising from major damage to the Morecambe gas facilities has been substantially covered by business interruption insurance.

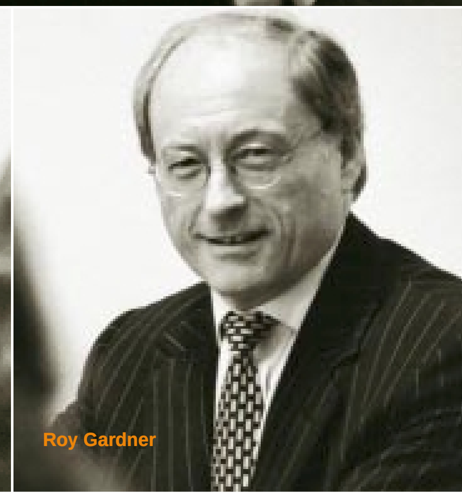
### Accounting policy changes

A description of accounting policies appears on pages 32 and 33.

The policies followed are consistent with those set out in the Listing Particulars issued in January 1997 with the exception of the presentation of deferred PRT charges, which are now included within cost of sales, whereas previously they were included within tax.




# Board of directors

**Sir Michael Perry, CBE, Chairman (64)*‡#** Sir Michael Perry became Chairman of Centrica plc on 1 July 1997. He was a non-executive director of British Gas plc from June 1994 until demerger. He is non-executive Chairman of Dunlop Slazenger Group Ltd, non-executive Deputy Chairman of Bass plc and a non-executive director of Marks & Spencer plc.

**Mike Alexander, Managing Director British Gas Trading (50)†** Mike Alexander joined British Gas plc as Commercial Manager, Exploration and Production in 1991, becoming Director CIS and Eastern Europe (E&P) in 1992, and Managing Director of Public Gas Supply in 1994. He was previously with BP from 1966, where he held a variety of management positions, both in the UK and overseas.

**Mark Clare, Finance Director (40)** Mark Clare joined British Gas plc in March 1994 as Group Financial Controller. He was previously with STC plc, which he joined in 1989 as Finance Manager in the telecoms business, where he rose to become Finance Director of STC Submarine Systems.

**Bill Cockburn, CBE, non-executive director (55)*#** Bill Cockburn is Group Managing Director of British Telecommunications plc. He was previously Chief Executive at both W H Smith Group plc and the Post Office Corporation. He is a non-executive director of Lex Services plc and a member of the Board for Business in the Community.

**Roy Gardner, Chief Executive (52)‡** Roy Gardner was appointed Finance Director of British Gas plc in November 1994. From November 1995 he had responsibility for the business units which subsequently formed Centrica plc. Prior to joining British Gas plc, he was Managing Director of GEC-Marconi Limited and a director of GEC plc. He is a non-executive director of Laporte plc.

**Peter Lehmann, Commercial Director (53)** Peter Lehmann joined British Gas plc in 1971. He has held a wide range of jobs in Gas Purchasing, Customer Service and International Business Development. Most recently, he was responsible for regulatory affairs and was Regional Managing Director, Europe.

**Francis MacKay, non-executive director (53)*** Francis MacKay is Chief Executive and Deputy Chairman of the Compass Group plc.

**Patricia Mann, OBE, non-executive director (60)†‡#** Patricia Mann joined the Board of British Gas plc in December 1995. She has just retired as Vice President International of J Walter Thompson Co Ltd but remains a director of JWT Trustees Ltd. She is on the Board of the UK Centre for Economic and Environmental Development and is a former director of the Woolwich Building Society and Yale and Valor plc.

**Peter Wood, CBE, non-executive director (51)†#** Peter Wood is Chairman of Privilege Insurance and Vice Chairman of Linea Directa Aseguradora. He was founder and former Chairman of Direct Line Insurance plc, Chief Executive of the Direct Line Group and a member of the Board of The Royal Bank of Scotland Group plc until June 1997. He is Vice Chairman of Direct Response Corporation and Homeowners Direct Corporation – auto and homeowners insurance companies in the US.

**Roger Wood, Managing Director British Gas Services (55)†** Roger Wood joined British Gas plc in April 1996. From 1993 to 1996 he was Director General of Matra Marconi Space NV. Previously he was Managing Director of STC Telecommunications and Group Vice President of Northern Telecom Limited. Prior to 1988 he was UK Director at ICL.

Member of: *Audit Committee †Customer Services Committee ‡Nominations Committee #Remuneration Committee

# Corporate governance

The Board considers that throughout the period covered by this report Centrica has fully complied with the provisions of the 'Code of Best Practice' published by the Committee on the Financial Aspects of Corporate Governance (the 'Cadbury Committee') and with Section A of the Best Practice Provisions annexed to the Listing Rules of the London Stock Exchange, introduced following the publication of 'Directors' Remuneration – Report of a Study Group chaired by Sir Richard Greenbury' (the 'Greenbury Report').

## The Board of directors

The Board meets regularly to consider matters specifically reserved for its attention and has delegated authorities to committees of directors, as set out below, on other specific matters. The Board is responsible for the strategic decisions regarding the Centrica Group business, including approval of commercial strategy, annual budgets, interim and full year accounts and dividend and accounting policies. It is also responsible for approving all material capital projects, investments and disposals.

The Board of Centrica plc consists of a non-executive Chairman and five executive and four other non-executive directors. The non-executive directors bring wide experience to the management of the Group and are a strong independent element of the Board.

Details of the directors' service contracts are contained within the Report of the Remuneration Committee on pages 23 to 27.

All the directors have access to the advice and services of the Company Secretary and the Board has established a procedure for any director to take independent professional advice, at the Group's expense.

## Board committees

The **Audit Committee**, which comprises Francis MacKay (Chairman), Bill Cockburn and Sir Michael Perry, reviews the adequacy and effectiveness of internal controls and compliance procedures within the Group and ensures that the principles, policies and practices adopted in the preparation of the Group's annual financial statements comply with all statutory requirements. The Committee may investigate or advise on these or any related matters which are referred to it or as it considers to be necessary. The Committee is also required to discuss with the Group's external auditors matters arising from their work and to encourage and monitor adoption of best practice in corporate governance.

The **Customer Service Committee**, which comprises Peter Wood (Chairman), Mike Alexander, Patricia Mann, Roger Wood, the Managing Director of British Gas Energy Centres and the Director of Corporate Affairs, is responsible for developing, monitoring and controlling those processes within the Company concerned with improving levels of customer service.

The **Executive Committee** is made up of the executive directors, the Company Secretary and other members of the senior management team. Roy Gardner acts as the Chairman of the Committee, which meets weekly to review and manage the business and to prepare submissions to the Board for consideration.

The **Nominations Committee**, which comprises Sir Michael Perry (Chairman), Roy Gardner and Patricia Mann, is responsible for proposing to the Board any new appointments of directors and certain senior management positions in the Centrica Group.

The **Remuneration Committee,** which comprises Patricia Mann (Chairman), Bill Cockburn, Sir Michael Perry and Peter Wood, is responsible for establishing remuneration policy and in particular the terms and conditions of employment and for setting the remuneration of the executive directors with due regard to the interests of shareholders.

## Internal control

The directors are responsible for the Group's system of internal control which aims to safeguard group assets, to ensure that proper accounting records are maintained, and to ensure compliance with statutory and regulatory requirements and the effectiveness and efficiency of operations. Any system of internal control can provide only reasonable and not absolute assurance, particularly against misstatement or loss.

Key features of the Group's system of internal control are:

### Control environment

Centrica is dedicated to the highest standards of business conduct with its customers, suppliers and partners. The Company Code of Conduct gives practical guidance on these matters.

The Group has an appropriate organisational structure as set out above for planning, controlling and monitoring the business.

### Identification of risks

Risk Awareness Committees are in operation throughout the Group which are responsible for the identification and evaluation of key risks applicable to their part of the business. These may arise from a variety of internal and external sources and include control breakdowns, changes in the business and regulatory environment, competition and natural catastrophe. These Committees are also responsible for ensuring that all key risks are allocated to a manager responsible for their management.

Millennium issues represent a significant threat to the Centrica Group, which relies heavily on computer systems. The Millennium threat is taken seriously and projects have been initiated to identify millennium issues, prioritise remedial action and implement appropriate solutions. These projects are managed at Business Unit level and co-ordinated and reported to the Board.

### Information and communication

Group businesses undertake annual strategic reviews which include consideration of long-term projections and evaluations of business options. Businesses are also subject to a detailed annual budget process. This ensures that agreed targets and objectives are communicated throughout the Group.

Performance during the year is monitored monthly against budget and full year forecasts are updated regularly during the year. These business results and projections are consolidated and presented to the Board. Changes required to improve performance are communicated from the Board to responsible management.

### Control procedures

The Group businesses operate procedures designed to ensure complete and accurate accounting, and to limit exposure to loss of assets and fraud. In addition, a framework of procedures are operated to ensure compliance with statutory and regulatory requirements and the effectiveness and efficiency of operations.

The internal financial control framework encompasses:

- a comprehensive budgeting system with annual budget approval by the Board,
- the monthly comparison of actual results against budget,
- 6-monthly reporting of the Group's performance,
- corporate and business unit manuals of accounting which are updated regularly, and
- clearly defined investment and expenditure control guidelines and procedures.

### Monitoring and corrective action

Risk Awareness Committees at Group and Business Unit levels, advised by the Internal Audit department, schedule a co-ordinated programme of Control Self Assessment and Internal Audits to review the adequacy of control within key activities. The results of these reviews are reported to the Risk Awareness Committee along with any associated remedial action required and form the basis of the internal audit report to Group Audit Committee.

The Group Audit Committee meets four times a year and approves the control review programmes. The Group Audit Committee receives reports on the state of control throughout the Group from internal audit and external audit. The internal audit report is supported by an annual letter of assurance in which business unit management confirm the adequacy of their systems of control and their compliance with Group policies. The letter of assurance also requires the reporting of any significant control issues which have emerged, so that areas of Group concern can be identified, experience shared and appropriate corrective action taken.

### Going concern

After making enquiries the Board has a reasonable expectation that the Company and Group have adequate resources to continue in operational existence for the foreseeable future. For this reason we continue to adopt the going concern basis in preparing the financial statements which are shown on pages 32 to 54.

## Report by the auditors to the directors of Centrica plc on corporate governance matters

In addition to our audit of the financial statements we have reviewed your statements on pages 21 and 22 concerning the Group's compliance with the paragraphs of the Cadbury Code of Best Practice specified for our review by the London Stock Exchange and the adoption of the going concern basis in preparing the financial statements. The objective of our review is to draw attention to non-compliance with Listing Rules 12.43(j) and 12.43(v), if not otherwise disclosed.

### Basis of opinion

We carried out our review having regard to guidance issued by the Auditing Practices Board. That guidance does not require us to perform the additional work necessary to, and we do not, express any opinion on the effectiveness of either the Group's system of internal financial control or corporate governance procedures nor on the ability of the Group to continue in operational existence.

### Opinion

In our opinion your statements on internal financial control on pages 21 and 22 and on going concern on page 22, have provided the disclosures required by the Listing Rules referred to above and are consistent with the information which came to our attention as a result of our audit work on the financial statements.

In our opinion, based on enquiry of certain directors and officers of the Company and examination of relevant documents, your statements on pages 21 and 22, appropriately reflect the Group's compliance with the other aspects of the Code specified for our review by Listing Rule 12.43(j).

Price Waterhouse

**Price Waterhouse**
Chartered Accountants
Southwark Towers, 32 London Bridge Street, London SE1 9SY
6 March 1998

# Report of the Remuneration Committee

## Remuneration Committee

The Remuneration Committee ('the Committee') consists entirely of non-executive directors, chaired by Patricia Mann; Bill Cockburn, Sir Michael Perry and Peter Wood. The Committee determines, on behalf of the Board, the remuneration packages of the Company's executive directors and supervises the remuneration of other members of the Executive Committee. The Committee's terms of reference are described on page 21. Its composition, responsibilities and operation comply with the best practice provisions in Section A of the Annex to the Listing Rules of the London Stock Exchange. In implementing its policy, the Committee gives full consideration to the provisions of Section B of the Annex to the Listing Rules.

## Policy on remuneration of executive directors

The Committee believes that in order to attract, retain and motivate key executives of the necessary calibre, the remuneration package offered must be performance related and market competitive. The Committee has adopted a benchmark market position of near the median on remuneration packages. A comparator group of FTSE 100 companies has been identified to reflect the fact that Centrica competes for its senior executives with other major companies in the energy, manufacturing and service sectors.

In line with market practice, the Committee has agreed a remuneration package for executive directors which comprises a number of different components, namely base salary, annual performance bonus and a long-term incentive scheme, together with pension and other employment benefits. To assist in making its decisions, the Committee draws upon survey data and advice provided by independent consultants.

In setting the level of base salary for executive directors and the opportunity to add to this by incentive arrangements dependent on individual and corporate performance, the Committee bears in mind the potential total remuneration available to executives and how this relates to that in other comparator companies. The Committee therefore retains discretion to vary individual elements of remuneration.

## Elements of remuneration

**Base salary:** The Committee seeks to establish a base salary for each executive director near the median level relative to the selected comparator group of companies, taking into account individual performance and drawing upon independent market data. Base salaries are reviewed annually, with comparisons being made with similar positions within the comparator group.

**Annual performance bonus:** In order to recognise performance against agreed goals, the Committee has approved an annual bonus scheme for its executive directors, similar to that applying to other senior executives in Centrica. Bonus payments earned by executive directors are determined by actual achievement against demanding Group objectives. If all are achieved in full, the scheme provides for a maximum payment of 50% of base salary. Bonus goals are approved by the Committee and currently relate to financial, customer service and personal objectives; for executive directors with business unit responsibilities, the scheme is structured to reflect business unit as well as Group performance. In 1997 the average annual bonus payment for the five executive directors was 38% of base salary.

With the exception of R A Gardner, whose bonus is not pensionable, the annual bonus payment for executive directors is pensionable (in common with other senior executives in the Company). The Committee concluded that this is appropriate because of the executives' previous terms of employment with British Gas plc. Since 1997 such pensionability is restricted in their case to a maximum of 20% of base salary.

**Long Term Incentive Scheme:** The Company operates a long-term incentive scheme, which links the award of shares to executive directors and other senior executives to total shareholder return.

Under the terms of the scheme, notional awards of shares may be made annually. Under normal circumstances, the shares will not be released to the participant for five or six years: that is, a performance period of three or four years, followed by a retention period of two years. This ensures that executives have a long-term interest in the Company's performance.

The number of shares eventually released to the participant depends on the comparative performance of the Company's total shareholder return. No reward for performance will be made if the total shareholder return over the performance period, when compared with all other companies in the FTSE 100 over that period, is ranked below 50th position.

At demerger existing awards were cancelled and replaced by awards over shares in Centrica plc.

No awards were made under the Long Term Incentive Scheme in 1996 prior to demerger; instead a special award was made in March 1997. An award was made under the scheme in October 1997 and future awards are expected to be made on an annual basis.

Details of the maximum numbers of shares which could be released to individual executive directors under the terms of the scheme are given on page 26.

## Benefits

In common with certain other management categories, executive directors are entitled to a range of benefits, including a company car, sharesave scheme, employee profit sharing, private medical insurance and a financial counselling scheme.

## Service contracts

All executive directors have service contracts which are terminable by either party with two years' notice. The Committee has considered that, as the Company applies the principle of mitigation strictly to any payment of compensation on termination and as the Company is competing with other major companies offering two-year notice periods, it is not appropriate to reduce this notice period at present.

R A Gardner and M S Clare, the executive directors proposed for re-election at the forthcoming Annual General Meeting, have service contracts which are terminable by notice to them of two years. F H MacKay, the non-executive director proposed for re-election, does not hold a service contract.

## External appointments

To broaden the experience of executive directors, it is the Committee's policy to allow each executive director to accept a maximum of one external appointment as a non-executive director of another company, fees for which are normally retained by the individual director. Details of individual directors' external appointments are given in their biographies on page 20.

## Non-executive directors

Non-executive directors joining the Board are appointed for a period of three years, subject to review thereafter. They are subject to reappointment at the Company's Annual General Meeting in accordance with the Articles of Association. Fees are set by the Board as a whole. The non-executive directors, including the Chairman, do not participate in any of the Company's share schemes, incentive plans or pension schemes.

## Directors' emoluments

| | Base salary/fees £000 | Benefits £000 | Annual performance bonus £000 | Total emoluments excluding pensions 1997 £000 |
|---|---|---|---|---|
| **Executive directors** | | | | |
| M R Alexander | 190 | 14 | 72 | 276 |
| M S Clare | 190 | 15 | 72 | 277 |
| R A Gardner | 336 | 24 | 133 | 493 |
| P J Lehmann | 170 | 11 | 63 | 244 |
| R N B Wood | 210 | 14 | 83 | 307 |
| | 1 096 | 78 | 423 | 1 597 |
| **Non-executive directors** | | | | |
| W Cockburn | 25 | – | – | 25 |
| R V Giordano | 113[a] | 17 | – | 130 |
| F H MacKay | 25 | – | – | 25 |
| P K R Mann | 25 | – | – | 25 |
| Sir Michael Perry | 96[b] | – | – | 96 |
| H Rabbatts | 4[c] | – | – | 4 |
| P J Wood | 25 | – | – | 25 |
| | 313 | 17 | – | 330 |
| **Total emoluments** | 1 409 | 95 | 423 | 1 927 |

a Emoluments received by R V Giordano in his capacity as Chairman up to 30 June 1997.
b Fees include those as Deputy Chairman up to 30 June 1997 and as Chairman thereafter.
c H Rabbatts served as a non-executive director until 21 February 1997.

Emoluments disclosed relate to the full year, except for R V Giordano who retired as a director on 30 June 1997 and H Rabbatts who resigned as a director on 21 February 1997.

In 1996 the Company did not trade, although the current directors were directors of the Company for part of that year they received no emoluments in respect of those services.

Of the total emoluments shown above, those paid up to 17 February 1997 in respect of R A Gardner, R V Giordano, P K R Mann and Sir Michael Perry have also been disclosed by BG plc, in compliance with statutory reporting requirements. The relevant emoluments paid up to 17 February 1997 in respect of R V Giordano amounted to £35,000.

## Directors' pensions

The following information relates to the pension arrangements provided for the executive directors. All the directors were members of the British Gas Staff Pension Scheme and will remain so until 1 April 1998, when they will transfer their past service and commence membership of the Centrica Staff Pension Scheme.

The Staff Scheme is a funded, Inland Revenue approved, final salary occupational pension scheme. Its main features are:

1) a normal retirement age of 65;
2) right to retirement at age 60 without reduction to a member's accrued pension;
3) accrual at the rate of 1/60th of pensionable earnings for each year of pensionable service;
4) life assurance cover of four times pensionable salary;
5) spouse's pension on death in service payable at the rate of two thirds of the member's prospective pension; on death after retirement, two thirds of accrued pension. Children's pensions are also payable;
6) members' contributions payable at the rate of 4% of pensionable earnings;
7) pensions payable in the event of retirement due to ill health;
8) pensions in payment and in deferment guaranteed to increase in line with the increase in the Retail Prices Index; and
9) there are no discretionary practices which are taken into account in calculating transfer values.

All benefits are subject to Inland Revenue limits. Where such limitation is due to the earnings 'cap', benefits are increased to the level that would otherwise have applied (P J Lehmann is the only director not affected by the 'cap'). Benefits in relation to earnings in excess of the limits are unfunded but an appropriate provision in respect of their accrued value has been made in the Company's balance sheet.

## Pension benefits earned by directors

| | Age at 31 December 1997 | Pensionable service at 31 December 1997 years | Directors' contributions paid during 1997[a] £ | Increase in accrued pension during 1997[b] £ pa | Accrued annual pension at 31 December 1997[c] £ pa |
|---|---|---|---|---|---|
| M R Alexander[d] | 50 | 19 9/12 | 3 342 | 7 300 | 71 600 |
| M S Clare | 40 | 3 10/12 | 3 342 | 6 000 | 15 000 |
| R A Gardner[e] | 52 | 3 1/12 | 12 532 | 17 000 | 35 000 |
| P J Lehmann | 53 | 26 5/12 | 8 160 | 12 500 | 82 800 |
| R N B Wood[e] | 55 | 1 9/12 | 3 342 | 10 100 | 13 600 |

a Contributions were paid in the year by the directors under the terms of the Scheme. R A Gardner has continued to pay contributions to the Scheme at the maximum rate of 15% of the earnings 'cap' in accordance with the pensions policy for executive directors prior to demerger.

b The increase in accrued pension during the year excludes any increase for inflation and any pension in relation to Additional Voluntary Contributions paid by members.

c Accrued pension is that which would be paid annually on retirement at age 65, based on service to 31 December 1997.

d The pensionable service shown for M R Alexander includes a service credit in relation to a transfer value from a previous employer's pension scheme.

e The pensions for R A Gardner and R N B Wood will accrue at the rate of 1/30th of pensionable salary per year of service to produce pensions broadly equivalent to the pension arrangements described in the Listing Particulars.

## Directors' interests in shares

The directors' interests in ordinary shares of Centrica plc during 1997 (which include those of their families) are shown below:

| | Beneficial interests | | Long Term Incentive Scheme | | | |
|---|---|---|---|---|---|---|
| | Ordinary shares[a] | | Notional allocation | | | |
| **Directors as at 31 December 1997** | **As at 31 December 1997** | As at 17 February 1997 | **As at 31 December 1997** | Awards made at 1 October 1997[b] | Awards made at 4 March 1997[b] | As at 17 February 1997[c] |
| M R Alexander | **22 034** | 2 034 | **596 722** | 205 184 | 282 843 | 108 695 |
| M S Clare | **25 471** | 471 | **534 492** | 205 184 | 282 843 | 46 465 |
| R A Gardner | **125 479** | 15 471 | **1 230 378** | 362 851 | 500 186 | 367 341 |
| P J Lehmann | **12 852** | 12 852 | **545 350** | 183 585 | 253 070 | 108 695 |
| R N B Wood | **50 000** | 4 000 | **539 398** | 226 782 | 312 616 | – |
| W Cockburn | **1 400** | 1 400 | **–** | – | – | – |
| F H MacKay | **–** | – | **–** | – | – | – |
| P K R Mann | **2 820** | 2 820 | **–** | – | – | – |
| Sir Michael Perry | **1 000** | 1 000 | **–** | – | – | – |
| P J Wood | **–** | – | **–** | – | – | – |

**Ordinary shares**

a Interests shown are beneficial interests in the ordinary shares of Centrica plc. Ordinary shares of 5p each were acquired in Centrica plc on 17 February 1997 as a result of the demerger of Centrica plc from British Gas plc, on the basis of one Centrica plc share for each BG plc share. Prior to 17 February 1997, the directors did not have any beneficial interest in the share capital of Centrica plc. Interests include shares acquired under the British Gas Profit Sharing Scheme at demerger, on the basis of one Centrica plc share for each BG plc share, which will be held for eligible directors under the terms of the Scheme and released at the same time as the BG plc shares three years from the date of allocation.

**Long Term Incentive Scheme**

b Notional allocations of shares were made on 4 March 1997 and 1 October 1997 under the Centrica Long Term Incentive Scheme, at a base price of £0.67175 and £0.73292 respectively. Figures given represent the maximum award possible if all performance criteria are met at the end of the performance period (three or four years) and would not be made until the expiry of the retention period (a further two years).

c Awards held by directors under the British Gas Long Term Incentive Scheme were replaced at demerger by awards over Centrica plc shares, with a base price of £0.817. These were on the same terms as existing awards, but the number of shares comprised in the award and the performance condition were adjusted to relate to the total shareholder return of Centrica plc since the original date of the award in October 1995. The total shareholder return of Centrica plc for the period up to demerger will be a proportion of the total shareholder return of British Gas plc in that period based on the ratio of the price of a Centrica plc share just after demerger to the price of a British Gas plc share just before demerger. These shares would normally be released at the discretion of the trustees in October 2000-2001.

None of the directors had any non-beneficial interests in shares.

At no time during the year or at the end of the financial year did the directors or their families have any beneficial interests in the share capital of any of Centrica plc's subsidiary or associated undertakings. There have been no changes in the interests of the directors in the share capital of Centrica plc or any of its subsidiary or associated undertakings between 1 January 1998 and 6 March 1998. Details of any contract of significance subsisting at the end of the financial year to which Centrica plc, or one of its subsidiary or associated undertakings, is a party and in which any director is or was materially interested are included in note 23 on page 53 of this report.

## Directors' interests in share options

Full details of the options over Centrica plc shares held by executive directors who served during the year and any movements in those options over the year are shown below. Options over shares in Centrica plc were not held prior to demerger, 17 February 1997.

| | Options held at 1 January 1997 | Options held as at 17 February 1997 | Options granted during year | **Options held as at 31 December 1997** | Exercise price £ | Date from which exercisable | Expiry date |
|---|---|---|---|---|---|---|---|
| **M R Alexander** | | | | | | | |
| Executive Share Option Scheme[a] | – | 86 145 | – | **86 145** | 0.90266 | Oct 1996 | Oct 2003 |
| | – | 288 969 | – | **288 969** | 0.81060 | Oct 1997 | Oct 2004 |
| Sharesave Scheme[b] | – | – | 7 435 | **7 435** | 0.46400 | Jun 2002 | Nov 2002 |
| | – | 375 114 | 7 435 | **382 549** | | | |
| **M S Clare** | | | | | | | |
| Executive Share Option Scheme[a] | – | 177 645 | – | **177 645** | 0.81060 | Oct 1997 | Oct 2004 |
| Sharesave Scheme[b] | – | – | 37 176 | **37 176** | 0.46400 | Jun 2002 | Nov 2002 |
| | – | 177 645 | 37 176 | **214 821** | | | |
| **R A Gardner** | | | | | | | |
| Executive Share Option Scheme[a] | – | 1 336 446 | – | **1 336 446** | 0.81889 | Nov 1997 | Nov 2004 |
| Sharesave Scheme[b] | – | – | 37 176 | **37 176** | 0.46400 | Jun 2002 | Nov 2002 |
| | – | 1 336 446 | 37 176 | **1 373 622** | | | |
| **P J Lehmann** | | | | | | | |
| Executive Share Option Scheme[a] | – | 161 254 | – | **161 254** | 0.66975 | Dec 1994 | Dec 2001 |
| | – | 106 331 | – | **106 331** | 0.67711 | Apr 1995 | Apr 2002 |
| | – | 54 239 | – | **54 239** | 0.90266 | Oct 1996 | Oct 2003 |
| | – | 72 835 | – | **72 835** | 0.81060 | Oct 1997 | Oct 2004 |
| Sharesave Scheme[b] | – | – | 14 870 | **14 870** | 0.46400 | Jun 2002 | Nov 2002 |
| | – | 394 659 | 14 870 | **409 529** | | | |
| **R N B Wood** | | | | | | | |
| Sharesave Scheme[b] | – | – | 37 176 | **37 176** | 0.46400 | Jun 2002 | Nov 2002 |
| | – | – | 37 176 | **37 176** | | | |

[a] **Executive Share Option Scheme**
Options granted to Centrica employees under the British Gas Executive Share Option Scheme were cancelled and replaced by options to acquire Centrica shares at demerger. The replacement options were granted on the same terms as British Gas Executive Share Options, with the same exercise date and aggregate exercise price per share and the number of shares placed under option was adjusted to take account of the demerger.

Options are no longer granted under this scheme.

[b] **Sharesave Scheme**
The Company operates a savings-related share option scheme, the Sharesave Scheme, which is open to all eligible employees. The Scheme is designed to provide a long-term savings and investment opportunity for employees and is described in Note 17 on page 46.

No options were exercised during the year under either scheme by any of the directors.

No options lapsed during the year.

The middle market price of a Centrica plc ordinary share on the last trading day of 1997 (31 December) was 90.25 pence. The range during the year was 95.25 pence (high) and 56.25 pence (low).

Patricia Mann

**Patricia Mann, OBE**
Chairman, Remuneration Committee
6 March 1998

# Directors' report

The directors present their report and the audited group accounts of Centrica plc for the year ended 31 December 1997.

## Demerger and associated events

The demerger to Centrica plc of the gas sales and trading, services and retail businesses of BG plc (formerly called British Gas plc), together with the gas production business of the North and South Morecambe fields, was approved by an Extraordinary General Meeting of the shareholders of British Gas plc on 12 February 1997. Shares in Centrica plc were officially admitted to the list of the London Stock Exchange and dealings commenced on 17 February 1997. At demerger shareholders received one share in Centrica plc for every one share held in British Gas plc. Under the demerger Centrica plc and BG plc have entered into agreements concerning the use of the British Gas name by each of them. Under the principal terms of these agreements BG plc assigned ownership in Great Britain of the 'British Gas' trade mark and Flame logo to Centrica plc whilst BG plc retained ownership of the trade mark and logo in the rest of the world.

## Related party transactions

Details of related party transactions are set out in note 23 on page 53.

## Principal activities

The principal activity of the Centrica Group for the financial year ended 31 December 1997 was the provision of gas and energy-related products and services to homes and businesses in Great Britain.

## Business review

The Chairman's statement, the Chief Executive's review and the Business review, comprise pages 1 to 15 and report on the activities of the Centrica Group during the year, recent events and any likely future developments of the business of the Centrica Group.

## Financial results

The financial results of the Centrica Group are discussed in the Financial review on pages 16 to 19 of this report.

## Dividends

The directors do not recommend the payment of a dividend for the year ended 31 December 1997. As explained in the Listing Particulars at the time of demerger, the directors do not currently anticipate that Centrica plc will pay dividends in the immediate future. There are a number of factors and events which will affect the level of dividend payments by Centrica in the medium term, including the extent and speed of penetration of competition into the domestic market for gas supply and the extent to which Centrica is able to reduce its costs. The Company has, however, made significant progress during 1997 in the reduction of the cost of its gas, including renegotiation of certain long-term gas purchase contracts.

## Creditor payment policy

Centrica aims to pay all of its creditors promptly. Special contractual terms apply for gas supplies. For all other trade creditors, it is the Company's policy to:

- agree the terms of payment at the commencement of business with that supplier;
- ensure that suppliers are aware of the terms of payment; and
- pay in accordance with contractual and other legal obligations.

The number of days' purchases outstanding as at 31 December 1997 is calculated at 31 days for the Group and 37 days for the Company.

## Research and development

Research and development is undertaken by individual businesses to develop and improve customer service techniques and production processes. £700,000 was charged in 1997 (1996 £nil).

## Employment policies

The Centrica Group employed an average of 15,423 people in the United Kingdom during 1997. The Group is committed to pursuing an active Equal Opportunities policy covering recruitment and selection, training, development, appraisal and promotion. The Group recognises the diversity of its employees, together with that of its customers and the community at large and seeks to use everyone's talents and abilities to the full. This approach extends to the fair treatment of people with disabilities, in relation to their recruitment, training and development. Full consideration is given to the retention of staff who become disabled during employment.

## Employee communication

The Centrica Group is committed to effective employee communications, which it maintains through company magazines, videos, tapes and briefing meetings. Formal communications with trade unions take place through regular meetings between representatives from the Company and trade unions. The Group has procedures for the timely and accurate communication of financial results and other significant business issues to its employees.

## Employee share option schemes

### Sharesave Scheme

Employees are strongly encouraged to become shareholders in Centrica plc and in 1997 6,738 staff were granted 51,760,195 options to purchase shares in the Company under the Centrica Sharesave Scheme.

### Profit Sharing Scheme

The Company recently announced its intention to activate the Profit Sharing Scheme in respect of 1997. All eligible employees will receive an equal number of shares to be held in trust for a three year period.

### Political and charitable donations

A full description of the Centrica Group's involvement in the community appears on pages 14 and 15. Charitable donations of £1.75 million were made during the year in the UK. No donations were made for political purposes.

### Share capital

The Company's authorised share capital as at 31 December 1997, together with details of shares issued during the year is set out in note 17 on page 46.

### Substantial shareholdings

At 6 March 1998, the Company had received notification from the Prudential Corporation plc that it had a material interest in 146,491,756 ordinary shares, which represents 3.30% of the Company's ordinary share capital.

### Directors

The present directors of the Company are listed on page 20. All served as directors throughout the year. Sir Michael Perry became non-executive chairman on 1 July 1997, following the retirement of R V Giordano from the Board on 30 June 1997, as agreed at the time of demerger. In addition, H Rabbatts resigned as a non-executive director on 21 February 1997.

In accordance with the Articles of Association M S Clare, R A Gardner and F H MacKay retire by rotation at the forthcoming Annual General Meeting and will be proposed for re-election.

Full details of the directors' contracts, emoluments and share interests can be found in the Report of the Remuneration Committee on pages 23 to 27.

### Auditors

Price Waterhouse have expressed their willingness to be reappointed as auditors of the Company. A resolution to reappoint them as the Company's auditors and authorise the directors to settle their remuneration will be proposed at the Annual General Meeting.

### Annual General Meeting resolutions

The resolutions to be proposed at the Annual General Meeting to be held on 24 April 1998, including a resolution to authorise the Company to purchase its own shares, together with explanatory notes, appear in the separate Notice of Annual General Meeting enclosed with this report.

By order of the Board

**Grant Dawson**

Company Secretary

6 March 1998

Registered Office:

Charter Court, 50 Windsor Road,

Slough, Berkshire SL1 2HA

Registered in England No: 3033654

# Statement of directors' responsibilities for preparing the financial statements

The directors are required by the Companies Act 1985 to prepare financial statements for each year which give a true and fair view of the state of affairs of the Company and of the Group as at the end of the financial year and of the profit or loss for the financial year.

The directors consider that in preparing the financial statements on pages 32 to 54, the Company has used appropriate accounting policies, consistently applied and supported by reasonable and prudent judgements and estimates, and all accounting standards which they consider to be applicable have been followed.

The directors have responsibility for ensuring that the Company keeps accounting records which disclose with reasonable accuracy the financial position of the Company and the Group and which enable them to ensure that the financial statements comply with the Companies Act 1985.

The directors have general responsibility for taking such steps as are reasonably open to them to safeguard the assets of the Group and to prevent and detect fraud and other irregularities.

# Report of the auditors to the members of Centrica plc

We have audited the financial statements on pages 32 to 54 which have been prepared under the historical cost convention and the accounting policies set out on pages 32 to 33.

### Respective responsibilities of directors and auditors

As described above, the Company's directors are responsible for the preparation of financial statements. It is our responsibility to form an independent opinion, based on our audit, on those statements and to report our opinion to you.

### Basis of opinion

We conducted our audit in accordance with Auditing Standards issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgements made by the directors in the preparation of the financial statements and of whether the accounting policies are appropriate to the Company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

### Opinion

In our opinion the financial statements give a true and fair view of the state of affairs of the Company and of the Group as at 31 December 1997 and of the loss and cash flows of the Group for the year then ended and have been properly prepared in accordance with the Companies Act 1985.

Price Waterhouse

**Price Waterhouse**
Registered Auditors
Southwark Towers, 32 London Bridge Street, London SE1 9SY
6 March 1998

# Financial statements – contents

# Principal accounting policies

## Accounting principles
The accounts have been prepared in accordance with applicable accounting standards and under the historical cost convention.

## Basis of preparation
**a) Merger accounting**

In accordance with the principles of merger accounting as set out in Financial Reporting Standard No. 6 ‘Acquisitions and Mergers’, the accounts have been prepared as if the Group had been in existence throughout 1996 and up to the demerger of the Centrica businesses from BG plc (formerly British Gas plc) on 17 February 1997.

**b) Consolidation**

The Group accounts comprise a consolidation of the accounts of the Company and all of its subsidiary undertakings and incorporate the results of its share of all associated undertakings.

**c) Acquisitions**

The results of undertakings acquired are consolidated from the date the Group gains control.

## Turnover
Turnover includes the value of gas supplied and reflects an assessment of gas supplied to customers between the date of the last meter reading and the period end (‘unread gas’). Unread gas is estimated for each individual customer based on seasonal/temperature profiles.

## Price regulation
Tariff gas prices to customers are subject to regulation under an agreed formula with Ofgas. Where revenues exceed the regulated maximum allowable amount, provision is made for rebating the excess to customers in the future. Where there is under-recovery of allowed revenues, no anticipation of any potential future recovery is made.

## Petroleum revenue tax
Provision is made on a unit of production basis for petroleum revenue tax expected to arise in the foreseeable future and is treated as a cost of sale. Changes in estimates are dealt with prospectively.

## Long Term Incentive Scheme (LTIS)
The cost of potential share awards under the Group’s LTIS is charged to the profit and loss account over the period to which the performance criteria of each allocation relates.

## Research and development expenditure
Research and development expenditure is charged to the profit and loss account as incurred.

## Tangible fixed assets
Tangible fixed assets are included in the balance sheet at cost, less accumulated depreciation.

Freehold land is not depreciated. Other tangible fixed assets, except exploration and production assets, are depreciated on a straight-line basis at rates sufficient to write off the cost, less estimated residual values, of individual assets over their estimated useful lives. The depreciation periods for the principal categories of assets are as follows:

| | |
|---|---|
| Freehold and leasehold buildings | up to 50 years |
| Plant and machinery | 5 to 20 years |
| Equipment and vehicles | 3 to 6 years |

Assets held under finance leases are depreciated over the shorter of the lease term or their useful economic life.

Exploration and production assets are depreciated from the commencement of production in the fields concerned, using the unit of production method based on the proved developed reserves of those fields. Changes in these estimates are dealt with prospectively. The net carrying value of fields in production is compared on a field-by-field basis, with the likely future net revenues to be derived from the estimated remaining commercial reserves. A provision is made where it is considered that recorded amounts are unlikely to be fully recovered from the net present value of future net revenues.

## Leases
Assets held under finance leases are capitalised and included in tangible fixed assets at cost. The obligations relating to finance leases, net of finance charges in respect of future periods, are included within borrowings. The interest element of the rental obligation is allocated to accounting periods during the lease term to reflect the constant rate of interest on the remaining balance of the obligation for each accounting period. Rentals under operating leases are charged to the profit and loss account as incurred.

## Fixed asset investments
Fixed asset investments are included in the balance sheet at the lower of cost or directors’ valuation.

## Stocks
Stocks are valued at the lower of cost or estimated net realisable value.

### Take or Pay' contracts

Where payments are made to external suppliers under 'Take or Pay' obligations for gas not taken, they are treated as prepayments and are included within debtors. Where necessary, a provision is made against these prepayments to reflect the directors' estimate of the difference between the payment made for gas not taken and the estimated net realisable value of that gas when taken.

### Abandonment costs

Provision is made over the life of the field for the estimated cost of well site restoration and pipeline and platform removal at the end of the producing lives of fields. The provision is calculated using the unit of production method and is based on proved developed reserves, price levels and technology at the balance sheet date. Changes in estimates are dealt with prospectively.

### Pensions

The cost of providing retirement pensions and related benefits is charged to the profit and loss account over the periods benefiting from the employees' services. The difference between the charge to the profit and loss account and the contributions paid to the Pension Schemes is shown as a provision in the balance sheet. The regular pension cost, variations from the regular pension cost and interest are all charged within employee costs and the straight-line method has been adopted for amortising surpluses and interest.

### Long-term sales contracts

Provision is made for the net present value, using a risk-free discount rate, of any expected losses on long-term sales contracts. The provision is based on the difference between the contracted sales price and the expected weighted average cost of gas.

### Deferred tax

Deferred tax, in respect of accelerated capital allowances and other timing differences, including pension provisions, is provided only to the extent that it is probable that a liability or asset will crystallise.

### Goodwill

On the acquisition of a subsidiary or associated undertaking fair values are attributed to the net assets acquired. Goodwill, which represents the difference between the purchase consideration and the fair values of those net assets, is taken to reserves. On disposal of a subsidiary or associated undertaking, goodwill previously taken to reserves is written back to the profit and loss account insofar as it relates to the disposals.

### Financial instruments

Derivative financial instruments are used by the Group mainly for the management of its foreign currency and interest rate exposures.

Forward exchange contracts are used to hedge the exposure within long-term gas purchase contracts to movements in foreign currencies. These contracts are matched at their inception to expected future purchases of gas within specific financial years. Gains and losses are released to the profit and loss account to match the costs of related future gas purchases. At a year-end, outstanding forward exchange contracts used as a hedge against forward purchases of gas are not revalued but are carried forward to match against the corresponding gains or losses on future purchases of gas.

Gains and losses under forward rate agreements used to reduce exposure to movements in short-term interest rates are amortised evenly over the notional period of each forward rate agreement.

# Group profit and loss account

for the year ended 31 December

| Notes | | 1997 Underlying business performance £m | 1997 Exceptional charges £m | 1997 Results for the year £m | 1996 Underlying business performance £m | 1996 Exceptional charges and demerger tax adjustments £m | 1996 Results for the year £m |
|---|---|---|---|---|---|---|---|
| | **Turnover** | | | | | | |
| | **– continuing operations** | **7 383** | **–** | **7 383** | 8 125 | – | 8 125 |
| | **– acquisition** | **459** | **–** | **459** | – | – | – |
| 2 | | **7 842** | **–** | **7 842** | 8 125 | – | 8 125 |
| 3 | Cost of sales | **(6 631)** | **(608)** | **(7 239)** | (6 996) | (705) | (7 701) |
| | **Gross profit** | **1 211** | **(608)** | **603** | 1 129 | (705) | 424 |
| 3 | Operating costs | **(1 036)** | **(227)** | **(1 263)** | (1 186) | (117) | (1 303) |
| | **Operating profit/(loss)** | | | | | | |
| | **– continuing operations** | **159** | **(835)** | **(676)** | (57) | (822) | (879) |
| | **– acquisition** | **16** | **–** | **16** | – | – | – |
| 2 | | **175** | **(835)** | **(660)** | (57) | (822) | (879) |
| | Profit on sale of tangible fixed assets | | | | | | |
| | – continuing operations | **–** | **–** | **–** | 2 | – | 2 |
| | **Profit/(loss) on ordinary activities** | **175** | **(835)** | **(660)** | (55) | (822) | (877) |
| 5 | Net interest | **39** | **–** | **39** | 39 | – | 39 |
| | Share of profits less losses of associated undertakings | **(2)** | **–** | **(2)** | 13 | – | 13 |
| | **Profit/(loss) on ordinary activities before taxation** | **212** | **(835)** | **(623)** | (3) | (822) | (825) |
| 6 | Tax on profit/(loss) on ordinary activities | **(168)** | **–** | **(168)** | (200) | (35) | (235) |
| | **Profit/(loss) on ordinary activities after taxation** | | | | | | |
| 18 | **and for the financial year** | **44** | **(835)** | **(791)** | (203) | (857) | (1 060) |
| | | **Pence** | | **Pence** | Pence | | Pence |
| 7 | **Loss per ordinary share – basic** | | | **(17.9)** | | | (24.1) |
| 7 | **Earnings/(loss) per ordinary share – adjusted** | **1.0** | | | (4.6) | | |

There were no recognised gains or losses other than those shown above.

The accounting policies on pages 32 and 33 together with the notes on pages 37 to 54 form part of these financial statements.

# Balance sheets

as at 31 December

| Notes | | Group 1997 £m | Group 1996 £m | Company 1997 £m | Company 1996 £m |
|---|---|---|---|---|---|
| | **Fixed assets** | | | | |
| 8 | Tangible assets | **1 716** | 1 869 | **1** | – |
| 9 | Investments | **26** | 10 | **235** | – |
| | | **1 742** | 1 879 | **236** | – |
| | **Current assets** | | | | |
| 11 | Stocks | **168** | 121 | **–** | – |
| 12 | Debtors (amounts falling due within one year) | **1 952** | 2 408 | **1 003** | – |
| 12 | Debtors (amounts falling due after more than one year) | **165** | 304 | **–** | – |
| | | **2 117** | 2 712 | **1 003** | – |
| 13 | Investments | **56** | 12 | **44** | – |
| | Cash at bank and in hand | **18** | 17 | **–** | – |
| | | **2 359** | 2 862 | **1 047** | – |
| | **Creditors (amounts falling due within one year)** | | | | |
| 14 | Borrowings | **(14)** | (177) | **(2)** | – |
| 15 | Other creditors | **(1 448)** | (1 278) | **(976)** | – |
| | | **(1 462)** | (1 455) | **(978)** | – |
| | **Net current assets** | **897** | 1 407 | **69** | – |
| | **Total assets less current liabilities** | **2 639** | 3 286 | **305** | – |
| | **Creditors (amounts falling due after more than one year)** | | | | |
| 14 | Borrowings | **(19)** | (30) | **–** | – |
| 15 | Other creditors | **(74)** | (3) | **–** | – |
| | | **(93)** | (33) | **–** | – |
| 16 | **Provisions for liabilities and charges** | **(1 235)** | (1 066) | **(9)** | – |
| 2 | **Net assets** | **1 311** | 2 187 | **296** | – |
| | **Capital and reserves – equity interests** | | | | |
| 17 | Called up share capital | **222** | 222 | **222** | – |
| 18 | Merger reserve | **467** | 467 | **–** | – |
| 18 | Profit and loss account | **622** | 1 498 | **74** | – |
| 19 | **Centrica shareholders' funds** | **1 311** | 2 187 | **296** | – |

The financial statements on pages 32 to 54 were approved by the Board of directors on 6 March 1998 and were signed on its behalf by:

**Sir Michael Perry, CBE**
Chairman

**Mark Clare**
Finance Director

The accounting policies on pages 32 and 33 together with the notes on pages 37 to 54 form part of these financial statements.

# Group cash flow statement

for the year ended 31 December

| Notes | | 1997 £m | 1996 £m |
|---|---|---|---|
| | **Operating activities** | | |
| 21a | Cash inflow from operating activities before exceptional expenditure | **1 028** | 43 |
| 21a | Expenditure relating to exceptional charges | **(653)** | (905) |
| 21a | Cash inflow/(outflow) from operating activities after exceptional expenditure | **375** | (862) |
| 21b | **Returns on investments and servicing of finance** | **45** | 42 |
| | **Taxation (paid)/received** | **(112)** | 4 |
| 21c | **Capital expenditure and financial investment** | **(87)** | (91) |
| 21d | **Acquisition** | **3** | – |
| | **Cash inflow/(outflow) before use of liquid resources and financing** | **224** | (907) |
| 21e | **Management of liquid resources** | **(44)** | (1) |
| 21f | **Financing** | **(178)** | 920 |
| | **Net increase in cash in the year** | **2** | 12 |

# Reconciliation of net cash flow to movement in debt, cash and money market investments

for the year ended 31 December

| | | 1997 £m |
|---|---|---|
| | **Net increase in cash in the year** | **2** |
| | Cash applied to reduce debt and lease financing | **178** |
| | Cash applied to increase liquid resources | **44** |
| | Change in debt, cash and money market investments resulting from cash flows | **224** |
| | New finance leases | **(5)** |
| | Movement in debt, cash and money market investments | **219** |
| 21g | Debt, net of cash and money market investments as at 1 January 1997 | **(178)** |
| 21g | **Cash and money market investments, net of debt as at 31 December 1997** | **41** |

No reconciliation of net cash flow to movement in debt, cash and money market investments is provided for 1996, as the Centrica businesses were financed by BG plc throughout that year.

The accounting policies on pages 32 and 33 together with the notes on pages 37 to 54 form part of these financial statements.

# Notes to the financial statements

## 1 Merger accounting and comparative information

On 17 February 1997, BG plc (formerly British Gas plc) demerged certain businesses (grouped together under GB Gas Holdings Limited (GBGH)), to Centrica plc. As explained on page 32, 'Basis of preparation', these Group accounts have been prepared as if the Centrica Group was in existence for the whole of 1996 and 1997. The profit for the GBGH Group, included within these financial statements, from 1 January to 17 February 1997 was £90 million (year to 31 December 1996, loss of £1,060 million).

Prior to demerger the companies comprising the Centrica businesses were transferred to GBGH, a subsidiary undertaking of BG plc. Upon demerger the share capital of GBGH was transferred to Centrica plc and was recorded at the nominal value of shares issued to BG plc shareholders. In accordance with Sections 131 and 133 of the Companies Act 1985, no premium was recorded on the shares issued. On consolidation, the difference between the nominal value of the Company's shares issued and the amount of share capital and share premium of GBGH at the date of demerger, was credited to a merger reserve.

The BG plc 1996 Annual Report and Accounts included pro forma financial information on the Centrica Group as though the demerger had been effective for the year ended 31 December 1996. The format of the disclosure of that information has been amended in two ways in the comparative amounts shown in these financial statements:

### a) Balance owed by BG plc to the Centrica Group

| In these financial statements the net balance of £91 million has been reclassified into its component parts as follows: | As at 31 December 1996 £m |
|---|---|
| Debtors (amounts falling due within one year): | |
| – 'Take or Pay' prepayments | 13 |
| – Transportation prepayments | 354 |
| – Trade | 10 |
| – Other | 25 |
| | 402 |
| Creditors (amounts falling due within one year): | |
| – Borrowings: | |
| – Obligations under finance leases | (10) |
| – Other | (160) |
| – Trade | (71) |
| – Other | (40) |
| | (281) |
| Creditors (amounts falling due after more than one year): | |
| – Borrowings: | |
| – Obligations under finance leases | (30) |
| | 91 |

### b) Treatment of petroleum revenue tax (PRT)

PRT is included within cost of sales whereas in the pro forma financial information included in the BG plc 1996 Annual Report and Accounts it was included within tax. The directors consider the inclusion within cost of sales to be a more appropriate treatment, consistent with that used for the cost of externally purchased gas and with that adopted for royalties on our own gas production. Deferred PRT charges were £25 million in the year ended 31 December 1997 (1996 £125 million).

## 2 Segmental analysis

Turnover, operating loss after exceptional charges and net assets are analysed below. Exceptional charges are explained in note 3 and have been charged to the following segments: Energy Supply £608 million (1996 £728 million), Services £33 million (1996 £91 million) and Retail £2 million (1996 £3 million). Windfall tax of £192 million (1996 £nil) did not relate to a specific segment. Turnover arose in the United Kingdom and net assets were located in the United Kingdom.

| | Turnover | | Operating profit/(loss) | | Net assets | |
|---|---|---|---|---|---|---|
| | **1997 £m** | 1996 £m | **1997 £m** | 1996 £m | **1997 £m** | 1996 £m |
| Energy Supply[a] | **7 192** | 7 498 | **(339)** | (523) | **1 543** | 2 378 |
| Services | **467** | 452 | **(82)** | (287) | **(30)** | (18) |
| Retail | **183** | 175 | **(47)** | (69) | **(14)** | 14 |
| Windfall tax | **–** | – | **(192)** | – | **(96)** | – |
| | **7 842** | 8 125 | **(660)** | (879) | **1 403** | 2 374 |
| Unallocated net liabilities[b] | **–** | – | **–** | – | **(92)** | (187) |
| Centrica Group | **7 842** | 8 125 | **(660)** | (879) | **1 311** | 2 187 |

a The effect of including Accord Energy Limited in 1997 was to increase turnover by £459 million and reduce the operating loss by £16 million. The net assets of Accord Energy Limited as at 31 December 1997 were £21 million.

| b Unallocated net liabilities comprised: | **1997 £m** | 1996 £m |
|---|---|---|
| Fixed asset investments | **26** | 10 |
| Interest bearing transportation prepayments | **271** | 354 |
| Accrued interest | **3** | – |
| Taxation | **(433)** | (373) |
| Debt, cash and money market investments | **41** | (178) |
| | **(92)** | (187) |

## 3 Costs

| | **1997** | | | 1996 | | |
|---|---|---|---|---|---|---|
| | **Underlying business performance £m** | **Exceptional charges £m** | **Total £m** | Underlying business performance £m | Exceptional charges £m | Total £m |
| Cost of sales:[a] | | | | | | |
| – continuing operations | **6 192** | **608** | **6 800** | 6 996 | 705 | 7 701 |
| – acquisition | **439** | **–** | **439** | – | – | – |
| | **6 631** | **608** | **7 239** | 6 996 | 705 | 7 701 |
| Operating costs:[a] | | | | | | |
| – continuing operations | **1 032** | **227** | **1 259** | 1 186 | 117 | 1 303 |
| – acquisition | **4** | **–** | **4** | – | – | – |
| | **1 036** | **227** | **1 263** | 1 186 | 117 | 1 303 |
| | **7 667** | **835** | **8 502** | 8 182 | 822 | 9 004 |

a Gas transportation costs of £2,501 million (1996 £2,873 million) are included within cost of sales. Distribution costs were not material and operating costs were all considered to be administrative expenses.

| 3 Costs continued | 1997 Underlying business performance £m | 1997 Exceptional charges £m | 1997 Total £m | 1996 Underlying business performance £m | 1996 Exceptional charges £m | 1996 Total £m |
|---|---|---|---|---|---|---|
| Costs include the following: | | | | | | |
| Contract renegotiations | **–** | **573** | **573** | – | 601 | 601 |
| Sales contract loss provisions | **–** | **35** | **35** | – | 104 | 104 |
| | **–** | **608** | **608** | – | 705 | 705 |
| Windfall tax | **–** | **192** | **192** | – | – | – |
| Restructuring costs | **–** | **35** | **35** | – | 117 | 117 |
| | **–** | **227** | **227** | – | 117 | 117 |
| Depreciation: | | | | | | |
| – owned assets | **202** | **–** | **202** | 220 | – | 220 |
| – leased assets | **9** | **–** | **9** | 6 | – | 6 |
| | **211** | **–** | **211** | 226 | – | 226 |
| Provision made for permanent diminution in value of fixed asset investments | **3** | **–** | **3** | – | – | – |
| Operating lease rentals: | | | | | | |
| – plant and machinery | **15** | **–** | **15** | 11 | – | 11 |
| – other | **1** | **–** | **1** | – | – | – |
| Year 2000 costs | **3** | **–** | **3** | – | – | – |
| Research and development | **1** | **–** | **1** | – | – | – |
| Auditor's remuneration: | | | | | | |
| – statutory audit (Company £0.2 million (1996 £nil)) | **0.7** | **–** | **0.7** | 0.8 | – | 0.8 |
| – other audit | **0.5** | **–** | **0.5** | 0.2 | – | 0.2 |
| – other | **0.6** | **–** | **0.6** | 1.3 | – | 1.3 |
| | **1.8** | **–** | **1.8** | 2.3 | – | 2.3 |

Exceptional charges are explained below.

### Contract renegotiations

During 1996 and 1997 the Group has renegotiated certain long-term 'Take or Pay' contracts which would potentially have resulted in commitments to pay for gas that would be excess to requirements or at prices above likely market rates. These renegotiations resulted in exceptional charges, representing the net present value of payments, due to the suppliers as consideration for the renegotiations, of £573 million (1996 £601 million). During the year £379 million was paid in respect of the exceptional charges booked in 1997, with a further £85 million relating to costs incurred in 1996, bringing total payments in 1997 to £464 million (1996 £516 million). The unpaid balance of the 1997 charge is included in creditors due within one year (£76 million) and provisions (£118 million). The amount included in provisions represents the net present value of the estimated payments due in periods between the years 2002 and 2008. The impact of all renegotiations announced by the date of these financial statements have been included.

### Sales contract loss provisions

The exceptional charge of £35 million (1996 £104 million) is to provide for expected losses resulting from certain long-term sales contracts. Provision is made for the net present value, using a risk-free discount rate, of expected losses based on the difference between sales price and the expected weighted average cost of gas.

### Windfall tax

The one-off windfall tax (£192 million), announced in the Government's July 1997 budget is not a tax on current profits and has therefore been included within operating costs as an exceptional charge. The first instalment of £96 million was paid in December 1997 and the final instalment will be paid in December 1998.

### Restructuring costs

The restructuring charge of £35 million, comprising severance and related pension costs, arose in Services and Retail. In 1996 similar charges of £117 million arose in Energy Supply, Services and Retail. The exceptional payments of £93 million in the year (1996 £389 million) represented £18 million against the 1997 restructuring charge, £26 million against earlier provisions and £49 million against creditors brought forward.

## 4 Directors and employees

### a) Employee costs

| | 1997 £m | 1996 £m |
|---|---|---|
| Wages and salaries | **342** | 438 |
| Social security costs | **28** | 38 |
| Pension costs | **30** | 56 |
| Long Term Incentive Scheme | **2** | – |
| Employee Profit Sharing Scheme | **5** | – |
| | **407** | 532 |

Details of directors' remuneration, share options, long-term incentive scheme interests and pension entitlements on pages 24 to 27 of the Remuneration Committee Report form part of these financial statements. Details of employee share schemes are given on pages 28 to 29 and in note 17 on page 46.

### b) Average number of employees during the year

| | 1997 Number | 1996 Number |
|---|---|---|
| Energy Supply | **5 365** | 6 793 |
| Services | **8 306** | 11 166 |
| Retail | **1 752** | 1 743 |
| | **15 423** | 19 702 |

All staff were employed in the United Kingdom.

## 5 Net interest

| | 1997 £m | 1996 £m |
|---|---|---|
| Interest receivable | **69** | 47 |
| Interest payable on bank loans and overdrafts | **(19)** | (6) |
| Finance lease charges | **(3)** | (2) |
| Notional interest arising on discounted items | **(8)** | – |
| Net interest receivable | **39** | 39 |

## 6 Tax

| | 1997 £m | 1996 £m |
|---|---|---|
| UK – corporation tax at 31.5% (1996 33%) | **204** | 242 |
| – demerger adjustments[a] | **–** | 303 |
| – group relief related to exceptional charges[b] | **–** | (268) |
| | **–** | 35 |
| – other group relief[b] | **–** | (32) |
| – deferred corporation tax: | | |
| – 'Take or Pay' provision | **–** | 27 |
| – deferred petroleum revenue tax relief | **(8)** | (41) |
| – other timing differences | **(18)** | – |
| – change in corporation tax rate from 33% to 31% | **(14)** | – |
| | **164** | 231 |
| – associated undertakings | **4** | 4 |
| Tax charge[c] | **168** | 235 |

a Certain deferred tax liabilities required provision upon demerger from BG plc.

b In 1996 the Group received £300 million from BG plc for group relief in respect of tax losses surrendered.

c The tax charge arose principally in respect of the profits from ring fenced activities. Losses arising elsewhere in the Group cannot be offset against these ring fenced profits.

## 7 Earnings/(loss) per ordinary share

Earnings/(loss) per ordinary share has been calculated by dividing the loss for the financial year of £791 million (1996 loss £1,060 million) by 4,416 million (1996 4,401 million), being the weighted average number of ordinary shares in issue during the year. For 1996 the weighted average number of BG plc shares in issue have been used on the basis of a one for one allotment on demerger. The Centrica Employees Share Trust's holding of 17 million ordinary shares has been excluded as the Trust has waived its right to future dividends. There would be no material dilution of earnings/(loss) per ordinary share if outstanding share options were exercised.

The directors believe that the presentation of an adjusted earnings/(loss) per ordinary share, being the basic loss per ordinary share adjusted for exceptional charges and demerger tax adjustments, assists with understanding the underlying performance of the Group. The reconciliation of basic to adjusted earnings/(loss) per ordinary share is as follows:

| | **1997** | | 1996 | |
|---|---|---|---|---|
| | **£m** | **Pence per ordinary share** | £m | Pence per ordinary share |
| Loss – basic | **(791)** | **(17.9)** | (1 060) | (24.1) |
| Contract losses and renegotiations | **608** | **13.8** | 705 | 16.0 |
| Windfall tax | **192** | **4.3** | – | – |
| Restructuring costs | **35** | **0.8** | 117 | 2.7 |
| Tax charge arising on demerger | **–** | **–** | 303 | 6.9 |
| Group relief related to exceptional charges | **–** | **–** | (268) | (6.1) |
| Earnings/(loss) – adjusted | **44** | **1.0** | (203) | (4.6) |

## 8 Tangible fixed assets

| | Land and buildings [a] £m | Plant, equipment and vehicles [b] £m | Exploration and production £m | Total £m |
|---|---|---|---|---|
| **Group** | | | | |
| **Cost** | | | | |
| As at 1 January 1997 | 82 | 256 | 2 544 | 2 882 |
| Additions | – | 60 | 2 | 62 |
| Disposals | – | (30) | – | (30) |
| **As at 31 December 1997** | **82** | **286** | **2 546** | **2 914** |
| **Depreciation** | | | | |
| As at 1 January 1997 | 23 | 92 | 898 | 1 013 |
| Charge for the year | 2 | 41 | 168 | 211 |
| Disposals | – | (26) | – | (26) |
| **As at 31 December 1997** | **25** | **107** | **1 066** | **1 198** |
| **Net book value** | | | | |
| **As at 31 December 1997** | **57** | **179** | **1 480** | **1 716** |
| As at 31 December 1996 | 59 | 164 | 1 646 | 1 869 |

The cost and net book value of the Company's tangible fixed assets comprised equipment of £1 million (1996 £nil).

a The net book value of the Group's land and buildings as at 31 December 1997 comprised freehold of £36 million (1996 £37 million), long leasehold of £15 million (1996 £15 million) and short leasehold of £6 million (1996 £7 million).

b The net book value of Group assets held under finance leases included above within plant, equipment and vehicles as at 31 December 1997 was £34 million (1996 £42 million). The related accumulated depreciation as at 31 December 1997 was £13 million (1996 £6 million). The Company had no assets held under finance leases.

## 9 Fixed asset investments

| | Group | | | | | Company[b] |
|---|---|---|---|---|---|---|
| | | Associated undertakings | | | | |
| | Own shares[a] £m | Shares £m | Loans £m | Other investments £m | Total £m | Total £m |
| **Cost and provisions** | | | | | | |
| As at 1 January 1997 | – | 7 | 11 | 1 | 19 | – |
| Additions | 13 | – | 17 | 2 | 32 | 235 |
| Change in investment in Accord Energy Limited | – | (5) | – | – | (5) | – |
| Long Term Incentive Scheme amortisation | (2) | – | – | – | (2) | – |
| Provisions | – | – | – | (3) | (3) | – |
| **As at 31 December 1997** | **11** | **2** | **28** | **–** | **41** | **235** |
| **Share of retained profits less losses** | | | | | | |
| As at 1 January 1997 | – | (9) | – | – | (9) | – |
| Change in investment in Accord Energy Limited | – | (4) | – | – | (4) | – |
| Retained profits less losses for the year | – | (2) | – | – | (2) | – |
| **As at 31 December 1997** | **–** | **(15)** | **–** | **–** | **(15)** | **–** |
| **Net book value** | | | | | | |
| **As at 31 December 1997** | **11** | **(13)** | **28** | **–** | **26** | **235** |
| As at 31 December 1996 | – | (2) | 11 | 1 | 10 | – |

| **Principal undertakings[c] as at 31 December 1997** | % Group holding in ordinary shares and net assets | Principal activity |
|---|---|---|
| **Subsidiary undertakings:** | | |
| Accord Energy Limited[d] | 100 | Wholesale energy trading |
| British Gas Energy Centres Limited | 100 | Sale of appliances |
| British Gas Services Limited | 100 | Servicing and installation of gas heating systems |
| British Gas Trading Limited | 100 | Energy supply |
| Centrica Reinsurance Company Limited | 100 | Insurance services |
| GB Gas Holdings Limited | 100 | Holding company |
| Hydrocarbon Resources Limited | 100 | Gas production from the Morecambe fields |
| **Associated undertakings:** | | |
| AccuRead Limited | 49 | Meter reading |
| AG Solutions Limited | 40 | Computer consultancy |
| Goldbrand Development Limited | 50 | Financial services |
| **Trade investment:** | | |
| Utilities Consortium Limited | 32 | Receipts processing |

a The investment in own shares represented The Centrica Employees Share Trust's investment in the Company's shares (17.4 million, 0.39% of the called up ordinary share capital), which had a market value as at 31 December 1997 of £16 million and a nominal value of £1 million. All other investments are unlisted and are held at the lower of cost or directors' valuation.

b The Company's investment represented £222 million of ordinary shares in GB Gas Holdings Limited and a £13 million loan to The Centrica Employees Share Trust.

c As at 31 December 1997, GB Gas Holdings Limited was a wholly owned subsidiary undertaking of the Company. GB Gas Holdings Limited held the investments in all other principal subsidiary and associated undertakings, except for AccuRead Limited and Hydrocarbon Resources Limited where the investments were held by British Gas Trading Limited. All principal subsidiary and associated undertakings were incorporated and operated in the United Kingdom with the exception of Centrica Reinsurance Company Limited which is incorporated in and operates from the Isle of Man.

d Other shares held in Accord Energy Limited are explained in note 10.

## 10 Change in investment in Accord Energy Limited

During the year the Group agreed with NGC Corporation (NGC) of Houston, Texas, to a reorganisation of the share structure of Accord Energy Limited (Accord), a company in which the Group previously held a 51% interest, but under a shareholders' agreement, could only exercise 50% of the voting rights. As a result of the share structure reorganisation, which was effective from 3 March 1997, the Group held the whole of the ordinary share capital and obtained operational control of Accord.

NGC's ordinary shareholding was converted into a 25% holding of preference shares in Accord and the Group has an option, which it is likely to exercise, to acquire those preference shares on or after 1 July 2000. The Group currently holds 75% of the preference shares in Accord. The change of control has been accounted for as an acquisition for deferred consideration. Third party preference dividend payments and the capital payment anticipated on exercise of the Group's option will be set against the deferred consideration of £98 million established upon change of control. Goodwill arising of £85 million has been written off directly against reserves.

| The assets and liabilities of Accord on the date of change in operational control are set out below: | Book value £m | Fair value adjustments[a] £m | Fair value £m |
|---|---|---|---|
| Current assets: | | | |
| Stock | 3 | – | 3 |
| Debtors (amounts falling due within one year) | 79 | 19 | 98 |
| Cash at bank and in hand | 19 | – | 19 |
| Net current assets | 101 | 19 | 120 |
| Creditors (amounts falling due within one year) | (95) | – | (95) |
| Net assets | 6 | 19 | 25 |
| Share of assets already owned | | | (12) |
| Net assets acquired | | | 13 |
| Goodwill (taken to reserves) | | | 85 |
| Additional investment represented by the net present value of deferred consideration[b] | | | 98 |

a A fair value exercise was performed as at 3 March 1997 resulting in changes to the valuation of certain current assets, principally to reflect the value of locked in, but unrealised, profits on forward gas sales contracts.

b The deferred consideration is the discounted value of the estimated stream of preference dividends payable to NGC and the capital payment to arise on exercise of the Group's option to acquire those preference shares. Of the deferred consideration, £16 million had been paid by 31 December 1997 and after discounting adjustments, £87 million remained outstanding within creditors.

The results of Accord have been included in the consolidated accounts of the Group from 3 March 1997, having previously been accounted for as an associated undertaking. Accord's profit after taxation for the year ended 31 December 1997 was £27 million (1996 £24 million). During the period 1 January 1997 to 2 March 1997, Accord's profit after taxation was £5 million. The Group's 51% share of Accord's operating profit before taxation for the period to 2 March 1997 of £4 million has been included within 'share of profits less losses of associated undertakings' (1996 £16 million). During the year Accord, as a subsidiary undertaking, contributed £21 million to the Group's net operating cash flows and paid £11 million of tax.

## 11 Stocks

| | **1997 £m** | 1996 £m |
|---|---|---|
| Gas in storage | **120** | 70 |
| Other raw materials and consumables | **15** | 15 |
| Finished goods and goods for resale | **33** | 36 |
| | **168** | 121 |

## 12 Debtors

**Amounts falling due**

| | Group 1997 within one year £m | Group 1997 after one year £m | Group 1996 within one year £m | Group 1996 after one year £m | Company 1997 within one year £m | Company 1996 within one year £m |
|---|---|---|---|---|---|---|
| Trade debtors | **475** | **2** | 534 | 9 | **–** | – |
| Accrued gas income[a] | **764** | **–** | 1 165 | – | **–** | – |
| Amounts owed by Group undertakings | **–** | **–** | – | – | **998** | – |
| Other debtors | **272** | **–** | 138 | – | **3** | – |
| Prepayments and other accrued income: | | | | | | |
| – 'Take or Pay' | **146** | **163** | 216 | 295 | **–** | – |
| – Transportation | **271** | **–** | 354 | – | **–** | – |
| – Other | **24** | **–** | 1 | – | **2** | – |
| | **1 952** | **165** | 2 408 | 304 | **1 003** | – |

a Accrued gas income is an estimate of money due from customers for gas consumed but not yet billed.

## 13 Current asset investments

| | Group 1997 £m | Group 1996 £m | Company 1997 £m | Company 1996 £m |
|---|---|---|---|---|
| Money market investments[a] | **56** | 12 | **44** | – |
| | **56** | 12 | **44** | – |

a Included £12 million (1996 £12 million) held by the Group's insurance subsidiary undertaking and accordingly was not readily available to be used for other purposes within the Group.

## 14 Borrowings

**Amounts falling due**

| | Group 1997 within one year £m | Group 1997 after one year £m | Group 1996 within one year £m | Group 1996 after one year £m | Company 1997 within one year £m | Company 1996 within one year £m |
|---|---|---|---|---|---|---|
| Bank loans and overdrafts | **4** | **–** | 7 | – | **2** | – |
| Funding by BG plc | **–** | **–** | 160 | – | **–** | – |
| Obligations under finance leases[a] | **10** | **19** | 10 | 30 | **–** | – |
| | **14** | **19** | 177 | 30 | **2** | – |

a Group obligations under finance leases after more than one year as at 31 December 1997 were repayable as follows: between one and two years £5 million (1996 £9 million); between two and five years £14 million (1996 £21 million); and after five years £nil (1996 £nil). As at 31 December 1997 the Company had no finance lease obligations (1996 £nil).

## 15 Other creditors

**Amounts falling due**

| | Group | | | | Company | |
|---|---|---|---|---|---|---|
| | **1997** | | 1996 | | **1997** | 1996 |
| | **within one year £m** | **after one year £m** | within one year £m | after one year £m | **within one year £m** | within one year £m |
| Gas Levy payable | **44** | **–** | 59 | – | **–** | – |
| Trade creditors | **476** | **–** | 663 | – | **1** | – |
| Amounts owed to Group undertakings | **–** | **–** | – | – | **866** | – |
| Taxation and social security | **251** | **–** | 147 | – | **–** | – |
| Accruals and deferred income | **343** | **4** | 174 | 2 | **11** | – |
| Windfall tax | **96** | **–** | – | – | **96** | – |
| Other | **238** | **70** | 235 | 1 | **2** | – |
| | **1 448** | **74** | 1 278 | 3 | **976** | – |

## 16 Provisions for liabilities and charges

| | As at 1 January 1997 £m | Profit and loss charge/(credit) £m | Utilised in the year £m | **As at 31 December 1997 £m** |
|---|---|---|---|---|
| **Group** | | | | |
| Abandonment costs | 61 | 11 | – | **72** |
| Pension costs | – | 18 | – | **18** |
| Restructuring costs: | | | | |
| – pension | – | 6 | – | **6** |
| – other | 27 | 29 | (44) | **12** |
| Sales contract loss and renegotiation provisions | 104 | 156 | – | **260** |
| Deferred petroleum revenue tax | 628 | 25 | – | **653** |
| Deferred corporation tax[a] | 238 | (40) | – | **198** |
| Other | 8 | 8 | – | **16** |
| | 1 066 | 213 | (44) | **1 235** |
| **Company** | | | | |
| Pension costs | – | 3 | – | **3** |
| Other | – | 6 | – | **6** |
| | – | 9 | – | **9** |

a Group deferred tax (assets)/liabilities comprise:

| | Amounts provided | | Potential amounts unprovided/(unrecognised) | |
|---|---|---|---|---|
| | **1997 £m** | 1996 £m | **1997 £m** | 1996 £m |
| Accelerated capital allowances | **403** | 465 | **16** | 16 |
| Deferred petroleum revenue tax relief | **(202)** | (207) | **–** | – |
| Other timing differences including losses carried forward | **(3)** | (20) | **(374)** | (82) |
| | **198** | 238 | **(358)** | (66) |

There were no potential deferred tax (assets)/liabilities for the Company (1996 £nil).

## 17 Called up share capital

| | 1997 £m | 1996 £m |
|---|---|---|
| **Authorised share capital of the Company** | | |
| 5 500 000 000 ordinary shares of 5 pence each | **275** | 275 |
| 100 000 cumulative redeemable preference shares of £1 each | **–** | – |
| **Allotted and fully paid share capital of the Company** | | |
| 4 436 200 823 ordinary shares of 5 pence each (1996 60 ordinary shares of 5 pence each) | **222** | – |

On demerger (17 February 1997), the Company issued 4,435,683,519 ordinary shares of 5 pence each to shareholders in BG plc in consideration for 100% of the share capital of GB Gas Holdings Limited on the basis of one Centrica share for each BG share held. The allotment of a further 999,960 ordinary shares to the shareholders prior to demerger of Centrica plc was cancelled.

| During 1997 the following ordinary shares were issued on the exercise of employee share options: | Executive Share Option Scheme | | Savings-related Option Scheme | |
|---|---|---|---|---|
| | **1997** | 1996 | **1997** | 1996 |
| Number | **467 210** | – | **50 094** | – |
| Nominal value | **£23 361** | – | **£2 505** | – |
| Consideration | **£350 241** | – | **£42 780** | – |

### Executive Share Option Scheme

Options granted to Centrica employees under the British Gas Executive Share Option Scheme were cancelled and replaced at the time of demerger by options to acquire Centrica shares. The replacement options were granted on the same terms as the British Gas executive share options.

Options over 6 million ordinary shares were outstanding as at 31 December 1997 (1996 6 million) and are exercisable at varying dates up to 15 November 2004 at prices from 66.975p to 90.266p per share.

No options were exercised by directors during the year. Details of outstanding options held by directors are given on page 27.

### Savings-related Share Option Scheme (Sharesave Scheme)

The Company operates a Savings-related Share Option Scheme, the Sharesave Scheme, which is open to all eligible employees including directors. The Sharesave Scheme is designed to provide a long-term savings and investment opportunity. Employees can save for periods of three or five years. Options over 52 million ordinary shares were granted during the year (1996 nil). Options over 49 million ordinary shares were outstanding as at 31 December 1997. These outstanding options are normally exercisable at varying dates up to November 2002 at 46.4p per ordinary share. Details of options held by directors under the Sharesave Scheme are given on page 27.

### Profit Sharing Scheme

The Company has established an employee profit sharing scheme (the Scheme) for the benefit of all eligible employees, including directors. The Scheme provides for the distribution to all eligible employees of a proportion of the Company's profit in the form of shares in the Company. Under the Scheme £5 million has been charged to the profit and loss account for the purchase of ordinary shares of the Company. As described on page 29 an allocation under the Scheme will be made in 1998 in respect of the 1997 financial year. When shares are allocated under the Scheme they will be placed in trust for employees for three years.

### Long Term Incentive Scheme

Full details of the Long Term Incentive Scheme (LTIS) can be found in the Remuneration Committee's Report on pages 23 and 26.

The Centrica Employees Share Trust (the Trust) has been established to acquire ordinary shares in the Company, by subscription or purchase, with funds provided by the Company, to satisfy rights to shares on the vesting of shares under the LTIS. As at 31 December 1997, the Trust had acquired 17.4 million ordinary shares at a cost of £13 million, financed by interest-free loans from the Company. The shares have a market value at 31 December 1997 of £16 million. All administration costs of the LTIS are borne by the Group.

## 18 Reserves

| | Group | | | Company[a] |
|---|---|---|---|---|
| | Merger reserve £m | Profit and loss account £m | Total £m | Profit and loss account £m |
| As at 1 January 1997 | 467 | 1 498 | 1 965 | – |
| Profit/(loss) for the financial year | – | (791) | (791) | 74 |
| Goodwill[b] | – | (85) | (85) | – |
| **As at 31 December 1997** | **467** | **622** | **1 089** | **74** |

a As permitted by Section 230(3) of the Companies Act 1985, no profit and loss account is presented for the Company.

b The cumulative goodwill taken to reserves as at 31 December 1997 amounted to £85 million (1996 £nil).

## 19 Movement in shareholders' funds

for the year ended 31 December

| | Group | | Company | |
|---|---|---|---|---|
| | **1997 £m** | 1996 £m | **1997 £m** | 1996 £m |
| Profit/(loss) for the financial year | **(791)** | (1 060) | **74** | – |
| Funding movements with BG plc | **–** | 366 | **–** | – |
| Net assets transferred from BG plc | **–** | 418 | **–** | – |
| Issue of shares | **–** | – | **222** | – |
| Goodwill written off | **(85)** | – | **–** | – |
| Net movement in shareholders' funds for the financial year | **(876)** | (276) | **296** | – |
| Shareholders' funds as at 1 January | **2 187** | 2 463 | **–** | – |
| Shareholders' funds as at 31 December | **1 311** | 2 187 | **296** | – |

## 20 Pensions

Substantially all of the Group's employees as at 31 December 1997 were members of either the British Gas Staff Pension Scheme (staff and management employees) or the British Gas Corporation Pension Scheme (industrial staff).

Pension schemes for the Group's employees are defined benefit schemes. The Schemes are self-administered and funded to cover future pension liabilities in respect of service up to the balance sheet date. They are subject to independent valuations at least every three years, on the basis of which the qualified actuary certifies the rate of employers' contributions which, together with the specified contributions payable by the employees and proceeds from the Schemes' assets, are expected to be sufficient to fund the benefits payable under the Schemes.

Centrica employees will continue to participate in the British Gas Schemes until 31 March 1998. From 1 April 1998 Centrica employees will be eligible to join one of two new pension schemes; the Centrica Staff Pension Scheme or the Centrica Engineers Pension Scheme. These new schemes will be defined benefit schemes providing identical benefits to the existing British Gas Schemes. A share of each of the British Gas Schemes' assets will be transferred to the corresponding new Centrica Schemes reflecting the share of the total accrued British Gas Scheme liabilities as at 31 March 1998 that is attributable to Centrica employees, or former employees, electing to transfer.

The Centrica Schemes will be immature with very few pensioners in contrast to the British Gas Schemes and this will be reflected in investment strategy and fund management objectives. Accordingly the long-term assumptions appropriate for use in actuarial valuations of the Centrica Schemes may differ from those previously applied to the British Gas Schemes. In consequence, from 1 January 1997, although Centrica employees will be provided with identical benefits to the existing British Gas Schemes, the bases for determining ongoing regular pension costs relating to Centrica employees will differ from those applying previously.

The long-term assumptions applied to calculate Centrica pensions costs for 1997 have been agreed as appropriate with the independent actuary after due consideration of the effect of abolition of ACT credits and are set out below:

| | From 1 January 1997 % |
|---|---|
| Rate of price inflation and pension increases | 4.0 |
| Annual rate of return on investments | 8.25 |
| Future increases in earnings | 6.0 |
| Dividend growth | 4.0 |

Calculations have been carried out using estimates of Centrica's share of the assets and liabilities of the two schemes as at 1 January 1997, in aggregate an actuarially assessed asset value of approximately £1,000 million, and the pension cost for 1997 has been based on these estimates. This actuarial value represented 121% and 112% of the respective Staff and Engineers Scheme benefits due to members calculated on the basis of pensionable earnings and service to 1 January 1997 (using the projected unit method) and allowing for projected increases in earnings.

The pension costs arising for 1997, together with unfunded pension costs, and the reconciliation to the balance sheet provisions were as follows:

| | British Gas Staff Pension Scheme £m | British Gas Corporation Pension Scheme £m | Total £m |
|---|---|---|---|
| Regular pension costs | 35 | 17 | 52 |
| Amortisation of surplus | (9) | (2) | (11) |
| | 26 | 15 | 41 |
| Interest | (9) | (2) | (11) |
| Net pension costs | 17 | 13 | 30 |
| Contributions paid | (8) | (4) | (12) |
| Provision for pension costs | 9 | 9 | 18 |
| Provision for pension related restructuring costs | 6 | – | 6 |
| Opening balance sheet provision | – | – | – |
| Closing balance sheet provision | 15 | 9 | 24 |

No pension cost analysis is provided for 1996 as it would not be meaningful to apportion a share of the costs of the British Gas Schemes given their different profile and assumptions. The net pension cost allocated to Centrica businesses by BG plc (formerly British Gas plc) in 1996, excluding that relating to restructuring, was £56 million.

## 21 Notes to the Group cash flow statement

### a) Reconciliation of operating loss to operating cash flow

| | 1997 £m | 1996 £m |
|---|---|---|
| Operating loss | **(660)** | (879) |
| Exceptional charges | **835** | 822 |
| Operating profit/(loss) before exceptional charges | **175** | (57) |
| Depreciation | **211** | 226 |
| Provisions for liabilities and charges | **67** | 138 |
| Decrease/(increase) in working capital: | | |
| – Stocks – (increase)/decrease | **(44)** | 9 |
| – Debtors – decrease/(increase) | **670** | (280) |
| – Creditors – (decrease)/increase | **(51)** | 7 |
| | **575** | (264) |
| Cash inflow from operating activities before exceptional expenditure | **1 028** | 43 |
| Expenditure relating to exceptional charges:[a] | | |
| – Contract renegotiations | **(464)** | (516) |
| – Windfall tax | **(96)** | – |
| – Restructuring | **(93)** | (389) |
| | **(653)** | (905) |
| Cash inflow/(outflow) from operating activities after exceptional expenditure | **375** | (862) |

[a] The relationship of exceptional payments to exceptional charges is explained in note 3.

### b) Returns on investments and servicing of finance

| | 1997 £m | 1996 £m |
|---|---|---|
| Interest received | **66** | 44 |
| Interest paid | **(20)** | (5) |
| Interest element of finance lease rental payments | **(3)** | – |
| Dividends received from associated undertakings | **2** | 3 |
| | **45** | 42 |

### c) Capital expenditure and financial investment

| | 1997 £m | 1996 £m |
|---|---|---|
| Purchase of tangible fixed assets | **(59)** | (98) |
| Sale of tangible fixed assets | **4** | 15 |
| Purchase of own shares | **(13)** | – |
| Loan to an associated undertaking | **(17)** | (8) |
| Loan to a trade investment | **(2)** | – |
| | **(87)** | (91) |

## 21 Notes to the Group cash flow statement continued

### d) Acquisition

| | 1997 £m | 1996 £m |
|---|---|---|
| Payment on change in investment in Accord Energy Limited | **(16)** | – |
| Cash acquired | **19** | – |
| | **3** | – |

| | 1997 £m | 1996 £m |
|---|---|---|
| Fair value of additional investment in Accord Energy Limited (see note 10) | **98** | – |
| Satisfied by: | | |
| – Cash | **16** | – |
| – Deferred consideration | **82** | – |
| | **98** | – |

### e) Management of liquid resources

| | 1997 £m | 1996 £m |
|---|---|---|
| Net purchase of money market investments | **(44)** | (1) |

### f) Financing

| | 1997 £m | 1996 £m |
|---|---|---|
| Net decrease in short-term debt | **(2)** | – |
| Net (decrease)/increase in funding from BG plc | **(160)** | 920 |
| Capital element of finance lease rentals | **(16)** | – |
| | **(178)** | 920 |

### g) Analysis of debt, cash and money market investments

| | As at 1 January 1997 £m | Cash flow £m | Acquisition £m | Other non-cash changes £m | As at 31 December 1997 £m |
|---|---|---|---|---|---|
| Cash at bank and in hand | 17 | (2) | 3 | – | **18** |
| Overdrafts | (5) | 1 | – | – | **(4)** |
| | | (1) | | | |
| Funding balances with BG plc | (160) | 160 | – | – | **–** |
| Bank loans | (2) | 2 | – | – | **–** |
| Finance lease obligations | (40) | 16 | – | (5) | **(29)** |
| | | 178 | | | |
| Current asset investments | 12 | 44 | – | – | **56** |
| | (178) | 221 | 3 | (5) | **41** |

## 22 Commitments and contingencies

### a) Capital expenditure

As at 31 December 1997, the Group had placed contracts for capital expenditure amounting to £3 million (1996 £nil). There were no capital expenditure commitments for the Company (1996 £nil).

### b) Abandonment costs

Total estimated future abandonment costs of the Group relating to exploration and production assets, at 31 December 1997 prices, were £187 million (1996 £187 million). These costs are expected to be eligible for tax relief. The amount provided by the Group as at 31 December 1997 was £72 million (1996 £61 million).

Centrica plc and its wholly owned subsidiary, Hydrocarbon Resources Limited, have agreed to provide security to a subsidiary of BG plc, BG Exploration and Production Limited, who, as original licence holder for the Morecambe gas fields, will have exposure to abandonment costs relating to the Morecambe gas fields should liabilities not be fully discharged by the Centrica Group. The security is to be provided when the estimated future net revenue stream from the Morecambe gas fields falls below 150% of the estimated cost of such abandonment. The nature of the security may take a number of different forms and will remain in force unless and until the costs of such abandonment have been irrevocably discharged and the relevant Department of Trade and Industry abandonment notice in respect of the Morecambe gas fields has been revoked.

### c) Lease commitments

As at 31 December 1997 operating lease commitments of the Group for the following year were:

| | Land and buildings | | Other | |
|---|---|---|---|---|
| | **1997 £m** | 1996 £m | **1997 £m** | 1996 £m |
| Expiring: | | | | |
| Within one year | **1** | 1 | **4** | 2 |
| Between one and five years | **1** | 1 | **11** | 10 |
| Thereafter | **14** | 13 | **–** | – |
| | **16** | 15 | **15** | 12 |

There were no material operating lease commitments for the Company (1996 £nil). The Company has guaranteed operating lease commitments of £5 million (1996 £nil), in respect of land and buildings of a subsidiary undertaking.

There were no commitments under finance leases entered into, but for which inception occurs after 31 December 1997 (1996 £nil) for the Group and Company.

### d) Litigation

The Group has a number of outstanding disputes arising out of its normal activities. Provision has been made for all expected losses.

### e) Year 2000/Euro

The Group was committed as at 31 December 1997 to £1 million of expenditure on Year 2000 modifications. No expenditure has been committed in respect of the introduction of the Euro. Estimated future costs are referred to in the Financial review on page 17.

### f) Guarantees and indemnities

The Company has a £1,000 million revolving credit facility. The major subsidiary undertakings of the Group have guaranteed, jointly and severally, to pay on demand any sum which the Company does not pay in accordance with the facility agreement.

The Group has indemnified BG plc in respect of payments and/or losses, damages, claims, expenses or liabilities of any nature arising out of or in connection with the Centrica Group's performance under certain long-term interruptible contracts which BG plc has guaranteed to third parties. Under the terms of the indemnity the Group will, in consideration of the guarantee, pay to BG plc a fee on each anniversary during the continuation of the guarantee.

Centrica plc and BG plc have agreed, subject to certain limitations, to indemnify each other against certain actual and contingent liabilities associated with their respective businesses.

## 22 Commitments and contingencies continued

### g) Gas purchase contracts

The Group is contracted to purchase 108 billion therms of gas (1996 132 billion therms) under long-term contracts at prices, mainly determined by various baskets of indices, which may exceed market prices from time to time. In the face of existing competition in the market for gas and with the prospect of further erosion of market share as full domestic competition is phased in during 1998, the directors have been reducing the Group's exposure by renegotiating reduced volumes and/or prices under certain contracts and by entering into long-term sales contracts. Since January 1996 these actions, affecting 57 billion therms, have been achieved at a net present cost to the Group of £1,313 million. Whilst there remains much uncertainty regarding future prices and market share, in the opinion of the directors, no general provision for losses is required.

The total volume of gas to be taken under these long-term contracts depends upon a number of factors, including the actual reserves of gas that are eventually determined to be extractable on an economic basis. Based upon the minimum volume of gas that the Group is contracted to pay for in any year, the profile of the contract commitments, after taking account of the renegotiations referred to above, is estimated as follows:

| | **1997 million therms** | 1996 million therms |
|---|---|---|
| Within five years | **55 400** | 66 800 |
| After five years | **52 800** | 65 000 |
| | **108 200** | 131 800 |

The Group's external weighted average cost of gas (WACOG) for the year ended 31 December 1997 was 19p per therm (1996 19p), including Gas Levy where appropriate. This WACOG will be reduced during the 1997/98 supply year as a result of the removal of the Gas Levy and will reduce from the 1998/99 supply year as a consequence of the price renegotiations referred to above. The WACOG will, however, continue to be subject to further movements in indices used to calculate the cost of gas, and for this reason the directors do not consider it feasible to estimate the actual future cost of committed gas purchases. Applying the external WACOG for the year ended 31 December 1997 of 19p per therm (1996 19p) would imply a financial commitment of approximately £21 billion (1996 £25 billion) for the Group.

| The gas purchase commitments over the next five years are as follows: | **1997 £m** | 1996 £m |
|---|---|---|
| Within one year | **2 700** | 2 800 |
| Between one and five years | **7 900** | 9 900 |
| | **10 600** | 12 700 |

### h) Tax dispute

The tax dispute referred to on page 47 of Centrica's Listing Particulars relating to the transfer price, for petroleum revenue tax and royalty purposes, of gas sold from the South Morecambe field for periods to 31 December 1997, has been resolved without cost to the Group.

### i) Other

The value of other commitments and contingencies as at 31 December 1997 amounted to £2 million (1996 £nil), none of which related to the Company.

## 23 Related party transactions

### a) BG plc

On 17 February 1997 the Centrica Group was demerged from BG plc (formerly known as British Gas plc). Prior to that date BG plc exercised control over all of the businesses within the Centrica Group and provided a number of group services to those businesses. All transactions between the Groups since 17 February 1997 have been on an arms length basis on normal commercial terms.

In both 1997 and 1996, the BG Group has been the largest supplier to the Centrica Group. During the year, purchases of gas, storage and transportation from the BG Group were material, and amounted to £2,804 million (1996 £3,041 million). The Centrica Group also sold gas to BG plc to the value of £128 million (1996 £114 million) and received interest on transportation prepayments amounting to £36 million (1996 £14 million). It has not been practicable to quantify all other, and less material, services arising between the Groups.

As at 31 December 1997 the Centrica Group had prepaid £271 million (1996 £354 million) for transportation charges and owed the BG Group £53 million (1996 £103 million) for gas purchases and other liabilities, principally finance lease obligations. Prior to demerger on 17 February 1997, the Centrica businesses were funded by BG plc. As at 31 December 1996 the funding balance was £160 million and upon demerger, the Centrica Group repaid the outstanding funding balance at that date of £505 million.

As described in note 20, employees of the Centrica Group will continue their membership of the British Gas Staff Pension Scheme or the British Gas Corporation Pension Scheme until 31 March 1998. From 1 April 1998 Centrica employees will be eligible to join new Centrica Schemes. A share in the assets of the British Gas Schemes will be transferred to the corresponding new Centrica Schemes reflecting the share of the total accrued British Gas Schemes' liabilities as at 31 March 1998 that are attributable to Centrica employees, or former employees, electing to transfer.

### b) Associated undertakings

Prior to the change in investment in Accord Energy Limited (see note 10), the Group purchased £4 million (1996 £4 million) of gas from and sold gas to the value of £9 million (1996 £57 million) to, Accord Energy Limited. The Group also purchased services with an aggregate value of £113 million (1996 £44 million) from other associated undertakings during the year.

In 1997 the Group lent £17 million (1996 £11 million) to Goldbrand Development Limited. As at 31 December 1997 the outstanding balance on the loan account was £28 million (1996 £11 million).

### c) Pension schemes

An appropriate share of the British Gas Staff and Corporation Pension Schemes' administrative costs amounting to £1 million, was borne by the Group. In 1996 these costs were borne by BG plc.

### d) Non-executive director

The Company and Privilege Insurance Company Limited entered into a Co-operation Agreement dated 11 December 1997 in respect of the trial marketing of home and contents insurance under the brand names British Gas Home Insurance and Goldfish Home Insurance. This was a related party transaction given that Peter Wood is able to exercise more than 30% of the votes able to be cast at general meetings of Privilege Insurance Holdings Limited, the parent company of Privilege Insurance Company Limited, and is a non-executive director of Centrica plc. Costs incurred during the year, pursuant to the Co-operation Agreement, were not material.

## 24 Financial instruments

### a) Fair values of financial instruments

For debtors, creditors, current asset investments, cash and debt, book values approximate to fair values.

### b) Exchange and interest rate risk

Exchange risk arises from exposure within long-term gas purchase contracts to the US Dollar/Sterling exchange rate and the Group's policy is to hedge part of this risk. Currently this exposure is hedged by the purchase of forward rate contracts and as at 31 December 1997, there were £9 million of net unrealised losses.

The Group manages short-term interest rate risk through the purchase/sale of forward rate agreements. These agreements are used to hedge in part against adverse movements in short-term sterling market interest rates.

# Shareholder information

## Analysis of shareholders as at 31 December 1997

| Distribution of shares by type of shareholder | Holdings | Shares |
|---|---|---|
| Nominees | 8 350 | 3 389 790 372 |
| Limited Companies | 1 875 | 173 912 796 |
| Banks | 39 | 124 038 |
| Insurance Companies | 52 | 80 160 404 |
| Pension Funds | 58 | 46 815 280 |
| Other Corporate Bodies | 991 | 25 728 562 |
| Individuals | 1 324 280 | 719 669 371 |
| Total | 1 335 645 | 4 436 200 823 |

| Size of shareholding | Number of shareholders | Number of shares held |
|---|---|---|
| 1 – 500 | 854 675 | 224 908 021 |
| 501 – 1 000 | 331 654 | 218 398 483 |
| 1 001 – 5 000 | 140 056 | 232 035 031 |
| 5 001 – 10 000 | 6 095 | 41 908 347 |
| 10 001 – 50 000 | 1 668 | 29 323 196 |
| 50 001 – 100 000 | 236 | 18 186 649 |
| 100 001 – 1 000 000 | 799 | 321 685 829 |
| 1 000 001 and above | 462 | 3 349 755 267 |
| Total | 1 335 645 | 4 436 200 823 |

## Registrar

Administration enquiries about the holding of Centrica shares (other than ADRs) should be directed to the Company's Registrar. Changes of address and name should be communicated to the Registrar promptly. The Registrar can be contacted as follows:

Lloyds Bank Registrars
54 Pershore Road South
Kings Norton
Birmingham B30 3EP
Telephone: 0121 433 4344

## Amalgamation of accounts

Shareholders receiving duplicate sets of company mailings due to multiple accounts in their name should write to Lloyds Bank Registrars to have their accounts amalgamated.

## American Depository Receipts

On 11 February 1998 Centrica introduced an American Depository Receipt (ADR) programme. The ADRs, each of which is equivalent to 10 ordinary shares, are issued by The Bank of New York. For enquiries on the ADR service, please contact our representatives at The Bank of New York by dialling 1 888 BNY ADRS inside the US and 001 212 815 5204 outside the US or by writing to The Bank of New York, Shareholder Relations, PO Box 11258, Church Street Station, New York, NY 10286-1258.

## CREST Share Settlement System

The Company entered the CREST system on 24 March 1997 and ordinary shares may be settled in CREST. Shareholders who wish to retain their share certificates are able to do so.

## SETS

On 20 October 1997, the London Stock Exchange introduced order-driven trading through the order book known as SETS, the Stock Exchange Electronic Trading Service for FTSE 100 Companies. The electronic order book allows the computerised matching of orders placed electronically by prospective buyers and sellers and increases choice by giving investors the option of dealing immediately at the available price or putting an order on the book to influence the price.

## Share apportionment and capital gains tax base cost of shares at demerger

Shares were acquired in Centrica plc at demerger from BG plc on the basis of one Centrica share for every BG share held at demerger. Shares in Centrica plc acquired on demerger from BG plc will be treated as having a base cost for Capital Gains Tax purposes ascertained by reference to the values of Centrica and BG shares on 17 February 1997, calculated in accordance with the provisions of Section 272 of the Taxation of Chargeable Gains Act 1992. The base cost of any holding of BG shares on that date will be adjusted on the same basis. The relevant prices on the London Stock Exchange on 17 February 1997 were: Centrica 64.25 pence; BG 173.25 pence. The base cost of the pre-demerger British Gas plc shares will be split between the post demerger Centrica and BG shares in the proportion: Centrica 27.053% and BG 72.947%.

## Share price

Details of the Centrica share price can be found on page 224 of Teletext and in the London Share Service pages 'Gas Distribution' section in the Financial Times.

## Centrica website

Extracts of this report and further information about the Centrica group can be found on the Centrica home page at www.centrica.co.uk

## Financial calendar

| | |
|---|---|
| Annual General Meeting | 24 April 1998 |

Whittle & Fleming Rooms
The Queen Elizabeth II Conference Centre
Broad Sanctuary
Whitehall
London SW1P 3EE

| | |
|---|---|
| Interim results | 10 September 1998 |

## Useful contacts

British Gas Home Energy – Head Office Telephone: 01784 645000
Energy Efficiency Advice: 0645 650650
British Gas Services – Head Office Telephone: 01784 874000
British Gas Energy Centres – Head Office Telephone: 0115 946 6700
Scottish Gas – Head Office Telephone: 0131 559 5000
Scottish Gas Services – Head Office Telephone: 01698 806100
Nwy Prydain Ynni Cartref – Head Office Telephone: 01222 239211
Business Gas – Head Office Telephone: 0990 909000
British Gas LP Gas – LPG Enquiries: 01784 645222
Centrica plc – Head Office Telephone: 01753 758000

# Index

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