Centrica Preliminary Results 2006

22 February 2007
Presentation Transcript

Slide 3: Chairman, Roger Carr

Very good, full house. Well good morning ladies and gentleman and welcome to the Centrica Results Presentation. I am joined this morning by Sam and Phil and in the front row by some members of the Executive team, Jake Ulrich, Deryk King, Chris Weston, Ian Peters, Grant Dawson. Catherine May and our new Finance Director Nick Luff, who I am sure will be known to many of you. We also have with us this morning Mary Francis, our Senior non Executive Director.

In a few minutes Phil will review the financial performance of the Group and Sam will provide a clear insight into his views on the Group and his plans for developing the business. Before we commence however I would like to say a few words to give some context to this morning's Presentation.

The results for the twelve months have been good and have been produced in conditions that have been the most turbulent and challenging since I joined the Board. Unprecedented wholesale cost escalation propelled retail prices to record levels and resulted in customer losses. This also triggered a substantial increase in customer inquiries to our call centres, already under strain at a time of major systems change and the delays here added to the dissatisfaction.

Upstream fire at the Rough platform in February shut down our storage facility for 16 weeks and unseasonably warm autumn and winter weather necessitated a reduction in volume from our production facilities towards the year end. Finally at Christmas we suffered the tragic loss of life in the Morecambe Bay helicopter accident.

In this difficult environment the team responded admirably to these challenges under the strong leadership of Sam who has demonstrated in adversity the qualities that I believe are now leading the Group to greater success in more favourable conditions. And the tide is turning. In recent months, new gas supplies have come on-stream underpinned by anchor contracts struck by British Gas, wholesale prices have fallen. We have begun to lower the cost base of the Group and we are improving our competitive position with reduced prices, our cashflows with reduced working capital and our service levels with better systems.

Our management team has been strengthened by the appointment of Nick Luff, fresh from his success at P&O to head the financial team at Centrica. This appointment in turn enables Phil to move to his new role as Managing Director of British Gas where he can bring his considerable knowledge to improve and develop our core consumer business.

In the medium term, lower wholesale prices should soften asset prices and enable us to underpin our supply position with a mixture of value creating asset purchases and attractive long term agreements. Shareholder value continues to be at the top of our agenda. And the Board's commitment to real growth in the ordinary dividend based on the solid foundation of sustainable profit growth remains firmly in place.

Equally over the passage of time, as we become more confident in the stability of more benign market conditions, we will be able to consider the reinstatement of our buyback programme should surplus funds permit.

In conclusion, while there is much to be done, I am confident that the improving conditions and the revitalised team under Sam's leadership, will ensure we have both the right business model and management quality for the creation and delivery of both customer satisfaction and future shareholder value.

I will now hand over to Phil.

Slide 4: Group Finance Director, Phil Bentley

Thanks Roger. Good morning everyone.

As you probably know, if my voice lasts, this is the last set of presentations I will be giving as Finance Director, after six years. After a brief handover with Nick I will be taking over at British Gas on 1 March. Now there is a lot to be done there, but I have got a great team who are really up for the challenge ahead of us. But obviously I will miss you all and I will miss occasions like today.

Now as usual we have given a pretty extensive disclosure so I will keep my comments fairly brief today.

Slide 5: Financial headlines

Turnover was up 22% to almost £16.5 billion. That improvement was mainly due to strong customer growth in North American business markets and to price increases in British Gas residential and British Gas Business. But operating profit was slightly down, by 5% to £1442 million, due to a lower pre tax contribution upstream as production has fallen. However tax charged was significantly down £163 million year on year and therefore our effective tax rate drops to 43%, from 52% in 2005- the result of the lower contribution from gas production in our profit mix. Therefore post tax earnings were a record £715 million. That is up 8% year on year on a continuing basis. With EPS up 7% at 19.4 pence per share. And we are proposing a final dividend of 8 pence per share, with our full year dividend up 6%. This reflects the Board's policy of continuing to deliver real dividend growth.

Now the final result is a little stronger than we had anticipated at the time of our trading update in December. We entered the 4th Quarter with much less cover than usual. And we turned Morecambe down, giving us exposure to low day ahead gas prices in the falling market. And we did this knowing that we could always turn up our operating flexibility from our production and from our contracts if the market had spiked back up.

Slide 6: Operating profit analysis

So let's go through each business unit's EBIT in turn. British Gas Residential made a full year profit of £95 million and our second half contribution was £238 million. And this encouraging second half provides me in my new role with a solid margin platform to build on.

Slide 7: British Gas Residential

Now the cost of sourcing energy was up £1.3 billion year on year. Both our weighted average cost of gas and electricity rose materially. But offsetting this, average pricing to end customers rose 29% in gas and 27% in electricity, bringing in £1.6 billion additional revenue.

Lower customer accounts, down just over a million in the period, reduced our profitability by £50 million. But our 17% price reduction in gas, announced earlier this month, signals our intention to remain far more price competitive this year. And warm weather, particularly towards the end of 2006 had a material impact on reducing demand, impacting profitability by £90 million. Our share of the gas imbalance costs of the national network increased by £90 million to some £175 million. We are working hard with the Regulator to make sure that gas costs are more fairly allocated across the entire industry.

Now our operating cost base did increase by £55 million. That is because underlying cost reductions were offset by one off costs associated with implementing price rises, systems dual running and staff back-filling while training customer service agents on the new systems. But despite this increase we remain firmly on track to deliver on our 2007 opex target. After savings from the additional '06 exceptional charge, Opex will be around £830 million, a full £200 million reduction from 2006.

Slide 8: Operating profit analysis

I would like to turn to the upstream business in the UK where operating profit actually fell 24% to £686 million.

Slide 9: Centrica Energy

Morecambe production was down 51% in the year and that alone reduced Centrica Energy's profits by £433 million. Although remember this is before our marginal tax rate there of 75%. That production decline was due to the extended summer maintenance period as well as the turndown in autumn and winter as the wholesale market softened. Obviously a partial offset to the lower volumes was the higher selling price for gas, up 46% at Morecambe to 58 pence a therm. And this contributed an extra £217 million. In addition our growing portfolio of gas and oil assets outside of Morecambe Bay contributed £279 million of profit. That is an incremental £69 million improvement year on year. Remember that this contribution is taxed at a much lower rate than Morecambe. And here gas volumes were up 16% and oil and condensate production up 47%. On the current lower gas curve we expect total gas volumes delivered in 2007 to be broadly flat on 2006, although clearly capacity is significantly greater than this.

And as we have considerably widened our search for upstream opportunities, Centrica Energy's opex has increased by £32 million on the year.

Slide 10: Operating profit analysis

Moving on to our growth businesses, British Gas Business has continued to perform well in a volatile market. We grew both customers numbers and load and during the second half of 2006 we delivered record profits of £76 million. Financial performance in Centrica Storage has been very strong this year. Profits were up 48% to £228 million an outstanding achievement after the fire. And we have already sold all of our storage capacity for the coming '07/'08 winter.

British Gas Services continue to grow well at the top line with total customer contracts up 4% now to 7 million. Operationally the new management team are getting a good grip of the business, after the problems in the first quarter of last year. And broken appointments have nearly halved.

North America had an excellent year. Operating profit here was up 21% at £223 million. We produced strong profit growth both in Texas and in home services. And our businesses in Europe posted a £7 million profit, despite carrying a £10 million amortisation charge.

Slide 11: Operating profit analysis

Now another reason why EPS came in slightly stronger was that we recognised a one off credit of £20 million, reported here in 'Other'. And this credit reflects the fact that since 'A' Day last year, more employees are commuting their pension entitlements to cash and this reduces our future liabilities. And this added a one off 0.4p to our EPS at the end of the year. Note also that, with our post tax pension liability on our balance sheet, is now only £207 million.

Slide 12: Cashflow and net debt

Turning now to cashflow and net debt. Excluding the non recourse debt from the water heater fund, net debt has increased by £467 million from a year ago to just over £1.5 billion. However as we predicted, that £1.5 billion is down from the half year by around £380 million. Working capital improved in the second half by £465 million, mainly due to resetting customer direct debits higher. And in 2007 we expect working capital requirements to be lower again as customer bills begin to fall.

Slide 13: Summary

So in summary, despite record wholesale prices during most of 2006 we have still produced solid financial results. British Gas has a lot to do operationally, but it is now in a much stronger competitive position following our announced price decreases. We expect British Gas Business which delivered record profits in '06 to comfortably exceed that in 2007. And British Gas Services is poised for significant profit growth this year.

And the legacy gas sales contracts in I&W which have been heavily loss making over the last couple of years will be profitable now in 2007. And that is earlier than previously anticipated. And once again we expect to achieve material growth in North America. So the business overall is making good returns on capital employed. Cashflow is healthy. The balance sheet is being strengthened and our growth prospects are improving.

So we head into 2007 in good shape to take advantage of the investment opportunities that our strategy is targeting. So on that positive note, let me sign off and hand you over to Sam.

Chief Executive's Review
Sam Laidlaw, Chief Executive

Slide 14: Sam Laidlaw: Business update

Thank you very much, Phil. Well good morning, everyone.

I think those of you who joined us in July will remember that I gave you some initial observations after just a few weeks on the job. I have now visited almost all the operations and I would like to give you some more considered thoughts on the shape and the potential of the company going forward.

Slide 15: We aim to be a leading……

But before I do that, let me just remind you what this company is all about. Centrica aims to be a leading integrated energy company focused on a few chosen markets, the UK, North America and Continental Europe. In these markets we will win through strong brands and distinctive assets and capabilities. That is how we are going to deliver top quartile shareholder returns.

Now there is no doubt that recent years have been tough. Average wholesale prices have gone from 17 pence a therm in 2002 to over 50 pence a therm in 2006. An almost threefold increase in four years.

Slide 16: The structure of the energy market is changing……

But there are now signs that things are changing. Wholesale commodity prices are falling. Additional pipeline capacity in the short term and great LNG availabilities longer term are changing the supply picture. And gas producers, especially national oil companies, are looking to secure long-term markets. They are looking for security of demand. And consumers' awareness of climate change is growing on both sides of the Atlantic. And in Europe the Commission is encouraging further market liberalisation, although clearly consolidation continues.

Slide 17: ……and Centrica is well positioned to take advantage

Centrica is well positioned to take advantage of all these changes. We have the largest share of the biggest gas market in Europe. And we also have the best recognised brand in the UK, British Gas. We have an unrivalled contractual portfolio including the substantial contracts through the new Langeled and BBL pipelines. And we also have upstream capabilities that set us apart from our competitors. Our enviable asset base of gas fields around the UK. Our fleet of modern gas fired combined cycle generators that give us the lowest carbon footprint of any of our suppliers. The ownership of Rough, a high value strategic storage asset. And our well developed mid stream and trading capability with our Accord business.

On top of that we also have a services business that has a nationwide deployment capability for a wide range of products and services. And most importantly we have a unique experience of competitive markets, both as a former incumbent and as a new entrant.

So what are we going to do to maximise on the opportunities that we have?

Slide 18: We are pursuing four priorites……

We are now pursuing four very clear priorities. We are firstly transforming British Gas, secondly sharpening up our organisation and reducing costs. Thirdly reducing risk through integration. And fourthly building on our multiple growth platforms. I will take you through each of these priorities in turn.

Slide 19: Priority 1: Transform British Gas

Our first priority is to transform British Gas and deliver sustainable profitability. We also aim to be consistently competitive. You saw from our price reduction a couple of weeks ago that we have now established a much more competitive price point. We currently have around 16 million customer accounts and for those customers who have left British Gas we will be targeting our new offer at winning them back. The response so far has been dramatic. Even though churn levels remain high across the industry, gross sales levels for us have increased sharply to around 85,000 last week. We will also continue to pass through to customers over time the movements in the wholesale price, both up and down the curve. But profitability has got to reflect the scale, complexity and the capital requirements of this business. And that really translates into through cycle margins in excess of 5%. And at our new price level we will still achieve that in 2007.

To firmly establish industry leading profitability, we also need to have industry leading productivity and efficiency. Phil mentioned earlier, we will reduce the British Gas Residential cost base by around £200 million. The majority of that £200 million will come from the streamlining of the business. The new systems are almost complete. In 2006 we went through a costly exercise of back-filling staff while training them on the new systems. That won't happen again in 2007. And the old legacy systems and their associated costs will also be removed during the year.

In addition, that programme has also allowed us to offshore some 2,250 jobs to India. These are back-office jobs. And we have outsourced our print centres and our mail room. We are closing the British Gas Headquarters building at Stockley Park. And as you saw we wrote down £178 million of redundant IT infrastructure in British Gas Residential alone which will save us non cash costs of around £30 million per annum.

We will deliver on our prior commitments to reduce costs but we will go further. Our cost base has to be reduced and then reduced again. And we will keep at it until we are truly best in class.

Slide 20: Priority 1: Transform British Gas- Improve our customer offer and service levels

To achieve the goals, the quality of our service and the attractiveness of our + customer offer, have to be consistently ahead of the competition. We are generally recognised as a leader in product innovation. We brought the first fixed price energy product to the market in 2004. And last year we followed that up with our fix and fall product. And our recent price reduction makes us on average one of the lowest priced energy suppliers in the UK.

We also launched a one year fixed price product at this new price level and announced the Essentials tariff to provide lower prices to three quarters of a million of our most vulnerable customers.

Now sustainability is not just about cost structure and pricing propositions. Improving the quality of our service in British Gas is management's critical short-term priority. Our key service metrics declined in 2006. A record number of tariff rises right across the industry did drive a huge number of calls. And that coincided with the transition to our new billing system. But we are now beginning to see early signs of progress in our service levels. Our call answering time has continued to improve since last year and we have now migrated 95'% of our customer base to the new billing system. And we expect to complete the migration by the end of this Quarter. We are committed to improving our service levels further. We know this can be done as you will see from the difference that we have already made in our services business.

Slide 21: Priority 2: Sharpen up the organisation and reduce costs

The second priority is to sharpen up the focus of the organisation and reduce the cost base across the whole of the business. In sharpening up, I have centralised and tightened some of the control mechanisms. As an example the capital allocation process is now much tighter. It is more systematic and based on common methodologies, screening criteria and hurdle rates. We have reduced the size of the corporate centre. But we are centrally tracking costs and performance more closely and systematically across the Group.

Within the businesses we are de-layering to drive accountability down closer to where the operational decisions are taken. We do have great people in Centrica, but we could do with more across the business and there are some areas where we do need to upskill. For example, upstream we are bringing in more people with the required technical skills and greater international experience. We have also changed the management team. We announced this morning the appointment of our new Finance Director, Nick Luff. He is well known to many of you and brings great experience and capability to the role. This frees up Phil to run British Gas and I am confident that he will drive British Gas to a new level of performance. And we appointed Catherine May as our new Corporate Affairs Director, to help bring a common thread to all of our communications activities.

Performance management is another area where we are becoming a lot more rigorous. Centrica will continue to reward high achievers, but we also need to be a lot better at removing people from the organisation who are poor achievers. We have also carried out a systematic review of our entire cost structure, not just in British Gas, but across all the businesses and in the central support area. We are going to continue to look deeper at the entire business, but we have already identified significant opportunities.

I am not going to set new targets at this stage, but the opportunities that I am talking about are now sufficiently grounded to make us confident that we can meet existing external expectations and move on. We have put in place clearer accountabilities and tracking mechanisms to ensure that what we have identified is actually delivered.

For me the emphasis here is on early results. For example. We have already slimmed down the corporate centre, removing roles and outsourcing a big piece of the central HR and Finance functions. That slimming down has saved some £7 million a year of overhead. The restructuring of British Gas services has removed £20 million of cost a year and gives us much better line of sight as we grow this business. And in North America we have reduced 450 jobs from the Direct Energy Organisation.

And across the Group that is only the beginning. We are pursuing the outsourcing of our IS Data centres and desktop replacement programme to a third party. And we are looking very closely at the structure of Centrica Energy and will extract savings here. We also have an ongoing review of our entire supply chain, which I believe will present more opportunities.

This business has to be fit to compete on both a domestic and an international playing field. There is a lot of opportunity here, but capitalising on that opportunity requires rigorous management and discipline.

Slide 22: Priority 3: Reduce risk through increased integration

Our third priority is to reduce risk through increased integration. In power, we have already made great progress. Over the last five years, we have acquired over 5 GW of generation capacity and since deregulation we have won around 6 million electricity customers here in the UK. The vast majority of our generation capacity is gas fired, very different to our competitors who own a lot of coal assets. These gas fired power stations emit less than half the CO^2 of an equivalent coal station. In 2006 coal stations were distinctly more profitable, allowing our competitors to effectively cross subsidise their residential supply businesses. That advantage has been rapidly eroded over the last few months now that gas and power prices have fallen. In fact over the last few weeks our gas fired power stations have actually been displacing coal generators even at base load. And clearly the benefits arising from free carbon allocation are going to continue to lesson as the emissions environment gets tighter.

We intend to build on our gas generation. We started construction of our new CCGT plant at Langage in Devon. That modern plant will add 885 megawatts to our portfolio when it comes on stream in two years time.

And renewables also feature heavily in our plans. We already have 190 megawatts of wind power in the UK. Further wind assets will help to make our input costs more stable under a wide range of scenarios and also help us to respond to climate change, building on our position as the supplier with the lowest carbon footprint. We will also make further investments in that space. We already have under construction 180 megawatts off the east coast and we recently applied for planning permission for the construction of a further 250 megawatts for the Lincolnshire Wind Farm.

Now in gas, part of the solution is through structural hedging by acquiring additional upstream assets. Building the gas asset base will be achieved by both focused acquisition and exploration for north sea supplies for the near term, and through LNG for the longer term. We have now set parameters within which we will focus both our geographical and technological capabilities. We will target our exploration in well understood hydrocarbon areas which allow delivery into the Atlantic basin. In the near term this will be the UK, Norwegian and North Sea areas. And will include the full exploitation of our current fields where we can share infrastructure and extend field life.

We have already had encouraging levels of success in the licensing rounds of the UK and Norway with the award of shares in six new blocks. Over the medium term, we will seek to exploit opportunities for LNG in areas such as Egypt. Qatar, Nigeria, Algeria and Trinidad. In those areas we will join partnerships with players who have existing operating capability and will leverage their technical expertise whilst offering access to the markets in return.

We will avoid technically challenging areas such as ultra deep water or ice prone acreage which will require the technology and project management skills of the super majors.

Slide 23: Priority 3: Reduce risk through increased integration- Become the downstream partner of choice for developing NOC's

LNG is a key area where we will be able to increase our integration. We have substantial gas demand in the complementary wholesale pricing markets of both the UK and North America. And we can provide optionality of pricing mechanisms- either US or European pricing- to maximise the returns for producers. We are therefore an obvious partner of choice for national oil companies. The national oil companies hold the rights to the vast majority of the world's undeveloped gas resources. And there is plenty of potential supply. In the Atlantic basin alone, on top of the current 135 billion cubic meters of capacity, there are some 28 liquefaction projects in various stages of planning or development capable of delivering a further 280 bcm of gas.

But it is security of demand that is becoming the key enabler for a lot of these projects. And we can supply that security of demand. Not only do we have the end customers, but we also have a strong balance sheet and a well recognised commercial capability to enter into long term contracts.

For national oil companies who would like to diversify their risk by taking on downstream exposure, we can offer that exposure in exchange for upstream positions and equity stakes in key LNG projects. And we are having those types of discussions right now.

Slide 24: Priority 4: Build on our multiple growth platforms- British Gas Service

Our fourth and final priority is to maximise the growth potential of our businesses outside the core UK residential energy business. We have four growth engines which we have already established. British Gas Services, British Gas Business, Europe and North America. And an opportunity which is rapidly becoming more defined in energy efficiency, a new growth area.

Firstly, in British Gas Services, we have a business with a unique position in the UK. BGS has over 8,500 fully qualified service engineers and a 24 hour deployment capability covering a truly national footprint. This business can continue to grow rapidly. In the short term we are broadening our offer to make major inroads into the on-demand market. But we will continue to innovate, bringing on attractive products which will widen our appeal and will continue to sell deeper into our energy customer base. Then on top of this we have got energy efficiency, which will become a big push for us and I will touch on that again in a moment.

But before we roll out a new range of energy efficiency services and products, we have to have best in class customer service. As I mentioned in July, we had a tough start to 2006 with a record number of callouts driven by the very cold weather in January and February last year. We have addressed the weaknesses in that area with a fundamental restructuring of this business. New management, new systems, and the de-layering of the supervisory levels to remove 390 positions. The leading indicators here are very positive with service quality up and complaints down. And you can see some of the statistics on the slide. The changes are very impressive. But this is by no means the end point. We are aiming to continually improve our service levels and we expect a substantial growth in profitability this year.

Slide 25: Priority 4: Build on our multiple growth platforms- British Gas Business

British Gas Business had a record second half in 2006. But we have got to push on from there and further differentiate ourselves from the competition. We are establishing a single point of contact for our entire customer base. There is a small upfront cost here but I am convinced that this will pay dividends in both customer loyalty and growth. And we have begun the rollout of smart meters in the business sector. This is the only way that we can ultimately take full control of the billing process. Customers really value the accuracy and the transparency that these meters bring.

By maintaining our high customer retention rates, delivering innovation in the customer offer and further developing the sales channels, we can grow the business well beyond where it is today.

Slide 26: Priority 4: Build on our multiple growth platforms- Grow in Western Europe along the gas supply routes

Continental Europe continues to remain an important area for us and I believe that we can make inroads here. But we will have to be both patient and realistic. The EU authorities are making all the right noises, but the ongoing tendency towards the creation of national champions does indicate that any progress in Europe may take some time. Now the UK gas market is becoming even more closely linked with Europe. Therefore we will aim to build our supply transportation, storage and trading positions along the key gas supply corridors of North West Europe to the UK. As the markets de-regulate Centrica's experience with competitive energy supply will be invaluable in capturing such opportunities.

Recent achievements in solidifying our positions in Belgium and Holland with the securing of long-term capacity rights and acquiring the off-take from the new combined cycle plant at Rijnmond do give us encouragement. The numbers however here are small, but these operations did move into profit in 2006 and we do expect to make further progress here this year.

Slide 27: Priority 4: Build on our multiple growth platforms- Grow in North America and diversify group earnings

North America however, is much more advanced and is now an important to the shape of the Group in its own right. It is an extremely profitable business and is becoming more important still as we start to move into an LNG world. Deryk King has grown that business over the last six years from scratch to a turnover now in excess of £4 billion, generating profits in 2006 of £223 million. We now have over 5 million customer relationships in North America. We have gas demand across Canada and the US of 9 billion cubic meters. And our power demand of 33 terawatt hours is nearly equivalent to the power demand of our UK business. Our gas demand in Canada and the UK combined with the UK and European demand of 34 billion cubic meters gives the Group an excellent profile to do business with large scale LNG suppliers.

Over the last year we have been actively developing our commercial supply business in the US North East. And we have been adding to our customer base and energy supply position in Texas, while slimming down the cost base with a 9% reduction in the head count. We intend to continue to concentrate on deepening our retail presence within the areas where we are already established in North America, developing our midstream capabilities to connect sources of gas with our customer demand. And where we see value we will be building on our upstream positions.

As in the past, this growth is likely to involve both organic and targeted acquisition activity. But we are not going to constrain the opportunities to the cashflow from North America. Provided we can see returns here, that are superior to other opportunities around the Group. The capabilities that we have developed, especially in marketing, services and energy management in North America will enable us to continue to make progress here.

Slide 28: Priority 4: Build on our multiple growth platforms- Become a leader in Energy Efficiency

The final new area is energy efficiency. We see the burgeoning interest in climate change as a real opportunity. Our energy savers support which was sent out by British Gas to some 8 million customers brought 1 ½ million responses. There is big demand for energy efficiency products and services across the Group. And our business is well positioned to lead in this area. Today we are already the biggest supplier of green electricity to the British consumer. And in 2006 we spent almost £100 million on our energy efficiency obligation. With the new Government programme we expect the annual cost of this obligation to double over the next three years. And for British Gas this represents a real opportunity to deliver energy efficiency advice, solutions and new technologies through our own business.

With our services business we are already the biggest installer of energy efficiency boilers in the UK. And we have a substantial business in North America. We therefore have a unique capability, systems and deployment processes to lead in providing energy efficient solutions both in the UK and in North America.

Slide 29: In summary

So let me summarise. The market is changing rapidly. And our core positioning puts us in the right place to take advantage of that change. Our aim is to become and to be recognised as being a leading integrated energy company in our chosen markets. We are committed to delivering top quartile shareholder returns and will do that by focusing and delivering on four priorities. We will transform British Gas. We will sharpen up the organisation and reduce costs. We will reduce risk through increased integration. And we will build on our multiple growth platforms.

I am greatly encouraged by the core business at Centrica. There is much to do, but I am excited by the opportunities that I and the new team see in front of us. I am keen to push on and execute our strategy and I am confident that we will deliver superior shareholder returns. Thank you.

Roger Carr

Thank you very much Sam. Questions and Answers. Clearly Sam and Phil will lead the responses. But we do have the top operational team here so the tricky ones will be passed out as always. We are relying on you for some really challenging questions for Phil today as it is his last opportunity.

Questions and Answers

Q1. Philip Green, Merrill Lynch:

Straight to Phil, but perhaps not on numbers, more on the future role. A few things caught my eye here. You mentioned about being more price competitive. I am sure you are not going to tell us what this literally means. But it would be helpful to frame your mind and to give us a clue to how you see your competitive position, vis a vis particularly the N-Power announcement and the likely SSE announcement. How far down will you go? What is your strategy going on from here? Secondly just on the costs, £830 million. I mean obviously that is a great achievement in the offing, but I wonder how that squares with the customer service challenge that you have, particularly given your signalling that you are not going to transfer all customers until March. And this seems like a big job of work there. Are you de-layering? My worry being that you are de-layering too fast and you end up with less people around, and actually the customer service challenge continuing beyond March? And finally just on the data issue which I think you have mentioned in the past about how you can effectively improve the data that is coming into the business to stop the exceptions being thrown out. I am not sure how you are going to achieve that. Maybe there is a clue there in what you were saying about the smart metering, but that is a costly business. But how do you change what is effectively an industry that has not really invested a lot in this area for a long time? Thanks.

Sam Laidlaw:

Let me Philip have a go at answering all of those and I will let Phil certainly build on that. In terms of pricing strategy, as you saw from our announcement two weeks ago, we were the cheapest and that is where we positioned ourselves. We have only had one competitor so far who has really moved. There was a move by one competitor just for new customers, but it wasn't significant. And interestingly enough, the move that we are talking about from N-Power on electricity which doesn't come into play until May and ours comes into play on 12 March, was only some 3% on electricity where most of their customers are. So we certainly expect that we will remain at a much more competitive price point than we were last year where we were undoubtedly at a substantial premium. We are amongst the lowest and in certain regions we certainly are the lowest still. We will see how our competitors respond. And in terms of opportunities for us to go further, much will depend on where the curve goes for forward future price. I would remind you that the end of the year, the fourth Quarter prices are still double the current spot prices. So we need to keep that in our mind as well. But we do think that there is, if the curve continues to move down there will be opportunity to go further, but critical in this is undoubtedly preserving the margins that we talked about in the Presentation.

I think in terms of the customer service question, you are absolutely right we need to balance taking costs out of the business with customer service. We have added actually some 800 people to the front office as a short term measure to improve customer service, but the cost reduction is really coming from the back office. The offshoring of the 2,000 positions to India and switching off the legacy systems. We do expect to be able to migrate the remaining few hundred thousand customers onto the legacy systems in March and will then be able to turn off those systems. So the big saving is really coming out of the back office, not the front office. And it is the front office that is really impacting service levels. Phil do you want to touch on the industry data issue?

Phil Bentley:
Picking up on your point about customer service. I mean frankly it is call volumes that drive costs in customer service. And if we can reduce the number of enquiries on bills for example, we see an immediate reduction in call volume and therefore costs to serve. So in our view a lower cost to serve is entirely consistent with better service. I think you also have to recognise that a big chunk of our costs on top of customer management is IS costs as Sam touched on, probably our second biggest single item and then the third biggest item is the processes by which we go through taking meter reads and collecting meter reads and collecting cash. And we think there is quite a lot of opportunities there as well. I think the point you make about the industry data flows I think is a good one. We get industry data flows obviously from the grid and from transfers from other suppliers. And I think it is important that we ensure that the data quality coming into our systems are appropriate and suitable and I know the team are having conversations now with third parties about the need to improve their data base. We find frankly that our databases are far more up-to-date now in terms of who is the supplier to the supply point? What is the meter reference point? And who is the occupier of the account? And it is the case of working backwards up the chain to improve that.

Q2. John Musk, Lehman Brothers:
Two questions, firstly on the £175 million gas imbalance, that is obviously a big chunk out of your residential margins. Can you just explain how this comes about, your understanding of why it is happening and I suppose what are the chances of this actually reversing in 2007? And then secondly on the potential reintroduction of the share buyback, what are the hurdles that you will need to go through before you are able to make any further announcement on that?

Roger Carr:
Why don't I respond to the buyback and then we can talk in more detail about the other aspects of the question. I mean we have tried to be very clear that if we look at it from a timing point of view first of all, we have just left a period of remarkable turbulence. We are going into a period which looks to be more benign, but we want to see that settle so that we can be comfortable with the shape of the business model which we have going forward financially. So just a common sense approach to some stability. The second I think is the consistency of the Board's commitment to shareholder value creation and in this context we will apply funds to those opportunities that are most valuable to shareholders. So if we find we have acquisition opportunities, whether returns are good or better than a return of funds to shareholders, then we would pursue those as our first priority. But if such opportunities do not occur and the funds are genuinely surplus and the circumstances appear reasonably stable, such that we could reintroduce it with a positive commitment, we would reintroduce it at that time. Positive mindset to shareholder value, that is the key.

Sam Laidlaw:
The first part of your question was around gas imbalances and you saw in Phil's presentation that there was a very substantial cost in 2006 which he identified. The gas imbalance phenomenon has always been there in that essentially what is happening is that we are paying National Grid as the shipper based on a certain volume and then we are selling to our customers a different volume and it is a higher volume that we are deemed to have shipped than we actually believe we have shipped. Now that is partly as a result of moves during the year of customer accounts, it is partly due to theft, it is party due to a whole host of different issues. Historically the costs of that have been disproportionately borne by British Gas because they have been allocated on a basis of share in the residential market rather

than share of the gas market as a whole and therefore industrial and commercial businesses have borne a disproportionate share of this. This is something that we are working with the Regulator to change to ensure that we actually bear less of the cost. But the reason the number was high in 2006 was actually a price phenomenon rather than the volume phenomenon. We have done a lot of work on this and satisfied ourselves that actually there was not a significant increase in volume of imbalance, it was just that that gas was much more expensive. So as prices come down, we would expect that imbalance to come down as well.

Q3. Colin Pollock, Credit Suisse:
Is it possible to have some indication of how net churn has been behaving after you announced the tariff cuts?

Sam Laidlaw:
The answer is, it is simply too early to say because we don't get good data. You will appreciate there is the 28 day cooling off period. What we do know is gross sales are substantially up, but it is just too early to give you a response as to what is happening to notifications and how many of those sales are sticking. We would expect to see a substantial improvement as a result of the dramatic increase in gross sales, but we can't be more specific at this stage because we don't have the data.

Q4. Jamie Tunnicliffe, ABN Amro:
Just a question on residential consumption. Obviously we are seeing quite a lot of volatility there with weather and potential efficiency and so on. Are you able to give your thoughts on what you think is the underlying position maybe going forward, to give us a hand on whether you see differences on gas and electricity and what you would expect or are planning on going forward?

Sam Laidlaw:
There is no doubt that it is very hard to get a good fix on at the moment because we have had these abnormal weather patterns. Clearly not just last year where we clearly had a very warm winter at the end of the year, but January 2007 has also been the warmest January for the last 25 years. So the warm weather has continued through the winter. And I think in terms of any forward projections, much of it depends on your view of weather patterns going forward for the balance of the year. There is no doubt that that has impacted gas more than electricity and I think we have got the numbers actually in the trading statement.

Phil Bentley: Yes just on that point Jamie, I mean gas consumption fell by just under 5% but it was the warmest year since records began, since 1649, you know we don't have the data that really can separate out the weather from the pricing effect. We would think that the majority is weather related more than pricing frankly. We certainly see that in electricity where consumption has not changed that much. Even though it was facing the same pricing increases we saw. Interestingly in BGB we actually grew consumption so we were signing up more customers, consuming more load and gas consumption there grew 14%.

Q5. Ian Turner, Deutsche Bank:
In the Statement you talk about volumes being flat in terms of production for next year, could you just talk a bit more about that because obviously this year your volumes have been down really I think it is a result of maintenance and a strong opportunity you have had in the market. And why you think you are going to see flat volumes going forward when perhaps from my perspective, I would have expected volumes to perhaps be higher next year compared to this year?

Sam Laidlaw:
It is a good question and the question is around gas production volumes as I understand it. And obviously this year was anomalous because of some of the maintenance that we did. Jake, do you want to speak about some of the new projects?

Jake Ulrich:
I mean there are two issues, one was the chillers we took that down so we were down an extended period over the summer. But I think Phil has talked about this before, the pricing structure and the tax structure we had last year was a lagging one so the taxes were based on forward prices and when we came into November and December, the current month ahead prices were much lower and which basically pushed it below buying gas in the market. Now even though we have moved over to a month ahead pricing scheme as far as taxation goes, we still sold significantly lower within day prices for January and February than previous. So we are in this period where in day prices are much lower, it doesn't make much sense to produce Morecambe now. Clearly at some point prices will bottom out and we will start to see prices turn around. We will see more production, but we have already lost a fair amount in January and February. So that is why the flat indication.

Q6. Edmund Reid, Cazenove:
I have three questions. The first one was on British Gas services. I was just looking at product holdings and it seemed like there was a slow down in growth. I think it was 4% for the year. And I was wondering whether that represented a sort of maturity in the market or whether it was due to the service problems that you had earlier in the year? That was the first question. The second question was on SBU prices. I just wondered whether you had seen any pressure on SBU prices? As far as I can see on my screen, there has been a convergence between summer and winter gas prices recently. That was the second one. And then the third one was just on what you were saying in terms of upstream. Before you talked about diversity in electricity generation, the impression I got from what you were saying today was that was less important, that you weren't looking at coal. So I just wanted to check that that was the case? Whether you are mostly focused now on renewables? And then whether nuclear had entered into your thinking at all? Thanks.

Sam Laidlaw:
I think the first question was around the organic growth of our services businesses and perhaps I could ask Chris Weston who runs our services business, to respond to that. Clearly as you indicated, we had 4% growth, we have very strong growth in the electrical side, but perhaps Chris you would like to speak to whether it was a result of difficulties at the beginning of the year and what the new growth trajectory is

Chris Weston:
Yes certainly. It is not maturity in the market, there is still a good opportunity out there. I think our market share, although it is relatively large in the core business of service repair, it is quite high, there is still a lot more market to go for particularly, if we start to look at different types of products and we are doing that at the moment. We introduced a new one in September and initial indications have been very positive from customers. We are also seeing high growth in the secondary products around electrical care as Sam said, 15% year on year and also on plumbing and drains etc, where we are about 5-6%. So we have good growth there. And I am expecting that to continue. The service issues from the end of last year, sorry end of '05 and the first Quarter of '06 were definitely a factor in churn of our customer base. That has become less of an issue now. You have seen some of the statistics, the improvements in the performance of the business. And operationally, even though

our workloads have been higher this winter, we have seen that the business has held up and offered a good level of service. So it is not maturity in the market.

Sam Laidlaw:
I think your second question was around the price of the standard bundled units for storage. And are the margins contracting between summer and winter? Grant would you like to speak to that?

Grant Dawson:
As Phil mentioned, we have already sold out the SBU's for '07 and '08 and as you know how the price for the SBU's are determined by the spreads. And those spreads are between the summer and the winter differential. And those spreads are contracting. So we are making some inroads in terms of the sales for '08/'09. But '07/'08 is actually sold out.

Sam Laidlaw:
And I think you final question which I will take, was around diversification of generation portfolio going forwards. Clearly we have a very strong position in gas and renewables and we will be building on that. We look at coal, we have a DRAX totalling agreement which comes into effect in October of this year. And I think the reality is that with coal and gas prices where they currently are, it is going to be difficult for us to invest in coal and reduce our average cost of electricity which at the end of the day is the ultimate task as that is what we clearly need to pass on to our customers. The exception might be clean coal, but that will be a long way out and a lot of work needs to be done on that. Nuclear, we have existing off-take agreement with British Energy and you know if and when new nuclear plants get built, which realistically is probably 10 years away, I certainly think we would have a role as an off-taker, but probably not as an investor.

Q8. Bobby Chada, Morgan Stanley:
I am afraid I had a couple of questions as well. First of all on gas production, I just wanted to make sure I understood. Are you saying that 2007 is a year of unusually low production because of January and February prices? You used to show us a very helpful chart of your expected production profile. On that old profile, 2008 I think would be an increase versus your forecast '07 production. Is that still something that we should be modelling? Secondly in the US, you sort of hinted you would be happy to look at acquisitions. I wondered if those would entail blocks of customers or only upstream? And if so what is the environment for such acquisitions look like? And then thirdly on the British Gas Residential Business, I wondered if you were able to disclose how many customers were either on fixed or Fix 'n' Fall contracts? And you used to give your WACOG and WACOE, it doesn't seem to be in the statement this year. I wondered if you were able to give that as well? That's it thanks.

Sam Laidlaw:
Let me hand over to Jake on the question of gas production. I think it is important to recognise that the way we run South Morecambe in particular is very price sensitive and therefore you know normal gas, normal forecasts of production in the same way that you would look at an E&P business aren't really appropriate for that. But Jake do you want to?

Jake Ulrich:
Again depending on the prices, I would expect that right now we are looking at '08 being higher than '07. Not significantly, but it will be, should be higher.

Sam Laidlaw:
The second question was around will we pursue acquisitions in North America? I indicated in the presentation that if the value is there, relative to other opportunities we see in the Group, we will. And I think you were interested as to whether we would look at blocks of customers rather than just upstream assets and perhaps I could hand that over to Deryk King to talk about what the market place is like both for upstream assets and for downstream opportunities?

Deryk King:
Yes I think that we concentrated more in the past year on organic development of our downstream business, although we did acquire 100,000 customers in Texas from Entergy. But the fact is that there may be one or two customer blocks that do come on the market over the next one to two years and if they do, of course we would be very keenly interested in acquiring those provided they produced value. And that is in both the residential space and the business space, but I stress those opportunities are likely to be few and far between as we go forward. In the upstream area on power, we have acquired three power stations in Texas as you know over the past couple of years. The landscape for power station acquisition seems to be very buoyant at the moment in terms of the prices being paid. And we have just seen BG pay 850 dollars a kilowatt in New England for a plant which is in our view significantly in excess of new build cost. So I suspect our acquisition activity on power generation will be highly specific and tailored to the sort of special situations that we have found in Texas. On upstream gas, there maybe significant value creating opportunities in Canada with the changes in income trust structure and the slight fall in gas prices that we have seen that some of the trusts are in difficulty. But as Sam said, our core activity is more in the European arena currently, so that would have to be very opportunistic and significantly value creating for us to be interested.

Sam Laidlaw:
I think the final part to your question was around how many customers do we have on fixed price contracts? And the answer to that is about 2.7 million of which 200,000 are on the fix and fall product. We are no longer selling the fix and fall product. All those contracts are in the money and that is where we currently are. Now the second part of your question is, you are absolutely right, you have spotted that we are not publishing either the weighted average cost of electricity or the weighted average costs of gas. We think that information is very valuable to our competitors. We are the only company that has historically published it and we think in publishing it we actually erode shareholder value so we are not publishing it going forwards.

Q8. Andrew Mead, Goldman Sachs:
I have two questions. One, your comment on industrial and wholesaling business being profitable in 2007, is a marked change from your December trading statement. I guess that is the movement of the wholesale gas curve. Is there something behind that statement that you have locked in some of that gas? Now will that move if the curve moves back up again? And the second question, your comment on the British Gas residential margin, through cycle being above 5%. Given where the curve is and the surplus in the gas coming into the market potentially, is 2007 and 2008 a time for it to be above the cycle margins?

Sam Laidlaw:
I think the first question was the industrial and wholesale contracts which were clearly loss making last year and you know even towards the end of last year we sort of expected to be loss making until 2009. You saw in the presentation we are saying they are going to be profitable this year. So there has been a big swing and you are absolutely right Andrew, it is entirely a function of the movement in the curve. And

have we locked that in? No, at the moment it is an open position. Your second question remind me was, are we at a higher placed than the average for the cycle, I guess is the question and therefore will we see higher margins than the 5% through cycle margins? I think that will all depend on two things. Obviously, one how the wholesale curve moves and the second being how the competitors respond. And I think it is recognising that where the only significant move so far has been made by us, it is too early to call.

Q.9 Andrew Wright, UBS:

I've got a couple of questions. One, I wonder if you could clarify what you mean by tightening up the investment appraisal process and in particular on that, there are a class of investments that you have which contribute to your strategic aim of reducing risk, would you treat those more favourably, perhaps requiring a lower return because they reduce the overall cost of capital of the Group by reducing volatility? Secondly, we have been skirting around the subject, I wonder if you could give us your view on gas markets going forward. What do you think the impacts of returning to normal weather conditions might be, what would be the impact of new sources of supply with Ormen Lange and LNG coming into the market next year. Do you think European markets will continue to be linked to oil or do you think the recent divergence from that is something that is here to stay?

Sam Laidlaw:

Let me respond to both of those Andrew. The first question around tightening up our capital allocation process. The big point here is that previously a lot of different business units have their own method of capital allocation within the business units. And we didn't have if you like a central ranking and gate-keeping process. Putting this together, obviously we want to make sure that all our projects, even if they are low risk and potentially are going to reduce the volatility of the earnings stream going forwards, do clear our cost of capital. And I think historically there is perhaps a bit of a temptation to take some below the cost to capital in the hope that you will have others that are significantly above the cost to capital and in my view that destroys shareholder value quite quickly. So that is the significant change. I think in terms of the view on gas markets, it is always a mistake to offer views on commodity prices, but I think the forward curve is telling us that over time, although there are substantial quantities of new gas coming in from Norway and the Netherlands and there will be LNG coming in, if the price is right. Over time the forward curve is suggesting that prices will move back up to the 35-40p range. Whether they will get back to the 70p range, that is not what the curve is telling us. The long term curve has clearly moved down.

Q10. Nigel Hawkins, Libertas Capital:

One clarification and two questions. Like Bobby and Ian, I am sorely exercised by the 2007 production forecast. Am I right in thinking that between March and December there will be a policy of partly and deliberately holding back production from Morecambe South? Secondly, clearly in Western Europe you haven't got critical mass, do you think there is real opportunity of getting critical mass over the next 2-3 years, particularly with all the corporate activity involving such companies as Nuon, Essent, Gas de France and others? And thirdly, one for Phil, since presumably he is demob happy, if possibly a trifle hoarse.

Nigel Hawkins:

You probably have seen in the papers that Vodaphone were desperately helpful and this was welcomed by shareholders in giving information about their financial calculations for the Hutchinson Essar deal. I wonder if perhaps you could give us a little bit of information following what the Chief Executive said in terms of your hurdle rates? Shareholders love hearing about hurdle rates.

Answer:
Let me deal with the first point which I think you used a rather emotive phrase that we are holding back production. Let's be quite clear about this. We produce Morecambe when it is economic to produce Morecambe and we don't produce Morecambe when it is not economic to produce Morecambe. And it is South Morecambe that we are talking about in particular and with gas prices at very low levels, it is more effective for us to go and buy gas in the market than it is to actually produce Morecambe. So that is what has been happening in recent months with very low spot prices. I think the second part of your question was around can we achieve critical mass in Europe? And the answer to that is we do see opportunities that could come if the unbundling legislation gets pushed through. That will depend on the outcome of the Council of Ministers Meeting 8-9 March. Even if that is not successful, there may be other opportunities such as for instance, if Suez and GDF were to merge, it is clear that the Commission and the Belgium Government have mandated divestments, including their 25% share in SPE which would be of interest to us. So there could be opportunities that actually come out as a result of the continued consolidation of that type. But I think we were very careful to say that we are going to have to be patient and we are going to have to be realistic. This is not going to be rapid growth in Europe.

Nigel Hawkins:
So we don't envisage any major acquisition over the next couple of years then?

Answer:
Two years is a long time to predict, but I think in the near term we don't anticipate any. You had a question on hurdle rates too?

Phil Bentley:
I am not sure I understood quite the question in terms of what Vodaphone have done, but obviously our weighted average cost of capital is around 8% and we have said that obviously in other jurisdictions whether it be Nigeria or Egypt we would expect a premium for country risk and also whether we were in the downstream or upstream part of the cycle and if it is upstream, whether it is a producing asset we would accept a lower level of risk. The point Sam was making is that there have been some which have just derisked the portfolio upstream, which were very skinny in terms of spread against WACC and I think that is the point there that it is just essential that we pushed the hurdles that bit higher up and made it harder for everyone to jump over it.

Q11. Richard Alderman, Merrill Lynch:
Perhaps if I could ask the WACOG question again in a way that you might perhaps be able to give us some information. At the time of the December pre-close statement, you specifically pointed out that you had gone into the winter and the calendar year shorter of gas than you had previous at the same point in the previous two years. And obviously in the last few months the price of Q1 gas has come down dramatically and the price of Q4 gas '07 has halved. It seems that the consensus WACOG amongst the top 20 analysts hasn't moved significantly since the pre-close trading statement, it is around 50 pence for WACOG, per therm. A few out lying analysts have moved to in the region of mid 40s. Could you give some guidance on

what you think analysts should be thinking about, because clearly some people might want to write follow up notes? Is it in the magnitude of a 10% fall or greater?

Sam Laidlaw:
No, I think we can't even go there. And I think you will understand why, because we would be unique amongst our competitors. Remember we already in terms of the level of disclosure, because many of our competitors are part of European Groups and it looks as if another of our competitors is about to become a member of a European Group. The disclosure that is required for them is considerably less than we already disclose. And I think we want to keep it that way.

Roger Carr:
We are very sympathetic to the modeling requirement, but we are pretty sure that you will be sympathetic to our commercial wish to be competitive and deliver good results and that is the conclusion we have drawn. But thanks for the question.

Any other questions? Right Phil you started, you can finish.

Q12. Philip Green, Merrill Lynch:
Just picking up that European champions point you were making. The obvious intrigue and I guess the obvious question is you know given national champions and the scale, you know the 100 billion euro club is a long way north of where you are and a number of other people are, and you have talked about potential for deals with NOCs and so on and so forth, but at the end of the day if you are a Chief Executive looking forward a next 3-5 year view on where this market is going, scale and influence is hugely important. How do you think you are going to be able to compete at the 20 billion euro level? Surely you should be looking for a more permanent strategic upstream partnership?

Sam Laidlaw:
I think the answer to you question Philip is with the amount of gas demand that we have, the largest share of the largest gas market in Europe and now growing gas demand in North America and the optionality of pricing that we have, we can actually engage in very good discussions with NOCs and we may not in a market Cap sense be the largest, but in terms of gas demand, we are the go to company for a lot of NOC's in Europe.

Roger Carr:
We think we have got an excellent strategic position short and long term.

Very good. Thank you all very much for coming. Thank you Phil for six very good and informative years and welcome Nick for the next time. Thank you all very much.

End of Presentation