Centrica Interim Management Statement

09 May 2011

Worldwide energy markets have been turbulent in the wake of the natural disaster and subsequent nuclear issues in Japan and unrest in North Africa and the Middle East. In the UK, the forward wholesale prices of gas and power for delivery in winter 2011/12 are currently around 25% higher than prices last winter, with end-user prices yet to reflect this higher wholesale market price environment.

Market conditions for our residential energy supply business are significantly more challenging than in 2010. Average residential gas consumption in the first four months of the year was 19% lower than for the same period in 2010, and electricity consumption was 4% lower, reflecting both the warmer weather this year, particularly in April, and underlying energy efficiency improvements. In addition, the business faces higher non-commodity costs associated with transmission, metering and environmental obligations which are further impacting profit margins. The 2011 result will be materially influenced by the recovery of higher wholesale prices and other costs in the retail price structure.

From a competitive perspective, British Gas is currently the cheapest supplier of electricity at average consumption of any major supplier in every region of Great Britain while the partnerships with Nectar and Sainsbury's are also contributing sales. As a result, the number of residential energy accounts on supply has grown in recent weeks to nearly 16 million accounts, slightly above the level reached at the end of 2010.

In March, Ofgem published its review of the UK retail energy supply market, setting out proposals designed to enhance competition, improve liquidity in wholesale electricity markets and improve the transparency in reporting of suppliers' profitability. We will continue to engage with Ofgem to ensure that the UK market remains competitive, providing customers with products that meet their needs while underpinning the investment that will be required over the coming years in the UK's energy infrastructure.

In residential services, we are now seeing the benefits of the agreement reached last year with our service and repair engineers regarding more flexible working conditions. However competition has increased from new entrants and the economic climate remains difficult for many households. Overall, the services business is expected to record further year on year growth in operating profit in 2011.

In business energy supply and services we continue to focus on increasing the value of our customer base and acquiring and retaining multi-site and SME customers where our retail skills give us a competitive advantage. Over time we also expect business energy services to play an increasingly important role.

Gas and oil production performance was strong during the first quarter and we are on track to achieve full year volumes in excess of 50 million barrels of oil equivalent, subject to the running patterns of our gas fields. The increase in wholesale prices is expected to result in higher year on year operating profit from our UK upstream gas and oil business, notwithstanding higher unit costs of production and the effect of selling forward a portion of the production volumes at historical prices. However the increase in the Supplementary Charge (SCT) rate from 20% to 32% on UK production announced in March in the Government's budget offsets the benefit of higher prices, with the tax rate on some of our UK gas and oil fields increasing to 81%.

In power generation, market clean spark spreads remained very low, below £5/MWh for much of the year to date. As a result our CCGTs generated 40% less power in the first quarter compared to the corresponding period in 2010 and we have taken the decision to move four of our power stations, representing around 20% of our capacity, into short term preservation mode - retaining the ability to return the units to service within 2-3 days if market conditions improve. Wind yields, while higher than in the same period of 2010, have been lower than expected due to the prevailing weather conditions. In contrast, nuclear output has been strong, with Centrica's share of first quarter output from the British Energy fleet totaling 3.0TWh.

We support the view that change in the electricity market is necessary in order to deliver decarbonisation and security of supply for the UK. We therefore welcomed the Government's decision to underpin the UK carbon price from 2013 as a first step to delivering cost effective carbon emission reductions, as part of their proposals for Electricity Market Reform (EMR). We have submitted our response to the EMR consultation and will continue to work closely with Government to ensure that an appropriate and early solution is achieved.

In gas storage, we announced in April that we had sold all standard bundled units for the 2011/12 storage year at an average price of 25.2p. This reflects the narrowing of summer / winter differentials, which will also impact the level of optimisation profit from the Rough asset, and as a result we now expect the operating profit of our Storage UK business to be around 40% of the level achieved in 2010.

In North America we continue to make good progress. In residential energy, churn levels in the US remain at the lower levels achieved towards the end of 2010 and we have increased our customer base organically in the US North East. In addition, in March we announced the acquisition of New York based energy retailer Gateway Energy Services, a transaction which will add 275,000 energy accounts and increase to more than 800,000 the total number of residential accounts in the North East. In Ontario, the introduction of the Energy Consumer Protection Act in January is making customer acquisition and retention more difficult and will lead to a reduction in our Canadian customer base in 2011. In Texas, residential energy profits were impacted by a spike in power prices during the extreme cold weather at the beginning of February, although this was largely offset by higher profits from our Texas CCGTs.

In business energy supply in North America, volumes of power sales in the first quarter were 17% higher than in 2010, as we continued to focus on increasing volume in the most attractive customer segments. In services, the integration of Clockwork is proceeding to plan and this business is now making a positive contribution to earnings. Upstream, we continue to be impacted by low gas and power prices across North America. The low price environment did provide us with the opportunity to acquire additional assets in the Wildcat Hills region of Alberta, providing an additional 45 billion cubic feet equivalent of reserves, lowering our overall unit cost of production in the region and maintaining our ability to meet approximately 35% of our downstream gas requirements from our own production. Overall in North America, business momentum is encouraging and we look forward to further growth in the remainder of the year.

The Group's interest charge is expected to fall to well below £200 million in 2011, reflecting the bond buy-back program undertaken at the end of 2010. At the end of the first quarter, net debt stood at £3.3 billion with margin cash held by counterparties of less than £100 million. Based on current estimates of the mix of profits, and reflecting the increased tax rates on UK oil and gas production, partly offset by the lower standard corporation tax rate, we expect the Group's effective tax rate for financial year 2011 to be around 45%. This equates to an increase in the tax charge of some £300 million on last year. We also expect to incur significant one-off deferred tax charges as a result of the increase in upstream tax rates.

In March we announced the disposal of the electricity and gas customer supply business of Oxxio, our subsidiary in The Netherlands, for €72 million. This transaction completes our withdrawal from European retail energy supply markets and is expected to close in June 2011.

Outlook summary

Centrica's integrated business model has become more robust against volatility in energy prices. Nevertheless the effectiveness of our economic hedge has been partially reduced by the UK Government's increase in tax rates for oil and gas production. With the resultant reduced cash flow and increased fiscal uncertainty, we no longer expect to maintain the previously projected high levels of investment in the UK. On new nuclear build, any impact on the investment schedule should be clearer following the publication of the interim report from the Office for Nuclear Regulation, due this month.

For the Group as a whole, increased pre-tax profits from our UK upstream business are expected to more than offset lower profits from the UK downstream business and from storage. We continue to expect growth in our 2011 group earnings but at a more modest rate than anticipated at the time of our last results announcement as upstream profits have become more highly taxed. The full year outturn remains subject to the usual variables, particularly retail margin recovery and weather.

Centrica is due to release its Interim Results for the first six months of 2011 on 28 July 2011.

Enquiries:

Centrica Investor Relations; 01753 494900

Centrica Media Relations; 0800 107 7014

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