Centrica Preliminary Results for year ended 31 December 2010

Presentation Transcript – 24 February 2011

Sir Roger Carr - Chairman

Well good morning ladies and gentlemen and welcome to the Centrica Preliminary Results Presentation. As usual, Nick will review the financial performance of the company and Sam will then comment on the strategic priorities, the operational highlights and the future prospects for the Group.

Before handing over to Nick, I wanted to make a number of points. 2010 was an excellent year in total, with strong performances from British Gas and their related service businesses. And an increasingly pleasing return from our North American activities under reinvigorated leadership.

Our upstream businesses faced the challenge of unfavourable wholesale price conditions, but the quality of the management was demonstrated by the skilful integration of Venture, the successful hit rate in our drilling programme, the relationships built in our nuclear partnership and the efficiency of our plant operation.

As announced yesterday, we are particularly pleased to have concluded a three year contract with Qatargas. LNG has in important role to play as domestic sources of gas decline. This agreement is the conclusion of three years of patient and very hard work by Sam, Mark, Nick and the rest of the team. And we intend that this groundbreaking transaction marks the beginning of a longer-term working relationship with the world's largest LNG exporter.

Downstream the overall margin achieved in the year was at the top end of our range, but was heavily weighted towards the first half with a mixture of lower costs and cold temperatures in the early months, counterbalanced by reduced prices and rising wholesale markets in the second half. By contrast we have entered 2011 with warmer weather, lower consumption and higher wholesale prices.

Management remain focused on reducing costs, improving service and creating competitive edge and are clear on the necessity of achieving financial returns that will permit the major investment programme that is required to meet the competitive, legislative and shareholder and national requirements for a sustainable, profitable, long-term business model.

I am also pleased that we will be recruiting 2,600 people into skilled jobs this year as part of this investment programme. A valuable contribution to the UK economy, alongside our tax contribution of over £700 million.

My final point is on Board Policy. We seek to achieve a balance by rewarding shareholders through increased dividend when appropriate to our financial performance. Delivering improved service and competitive pricing for customers and caring for the disadvantaged in the community, through attractive financial terms and support in energy efficiency measures. As a Board we are aware of our responsibilities and look to the Government and Regulators in providing a fair and level playing field, efficient and effective planning measures, appropriate financial incentives for long-term investment commitments, and importantly, a climate of public opinion that recognises the critical role of sustainable energy in our society. We believe it is through this combination that the current success of Centrica will be preserved and developed for the future to the benefit of all stakeholders.

I will now hand over to Nick.

Nick Luff - Group Finance Director

Thank you Roger. Morning everybody. As usual, let me start with some commodity price context. As you all know, 2010 was a year of rising gas and power prices. Gas prices of course are still well short of parity with oil, but if you remember they were just 30 pence per therm this time a year ago, despite the high demand we had at the time due to the cold weather. Whereas today they are up around 55 pence a therm. And the forward curve would of course imply that that will be sustained through 2011 with very little seasonal variation. Power prices in the UK have followed gas prices up as you would expect. But spark and dark spreads of course have been depressed, under £10 for much of last year and forecast to remain so for the rest of this year.

In contrast to the UK, North American Gas and Power prices remain very low. Shell Gas has left the market well supplied without the need for LNG imports and that has resulted in a complete disconnect between prices elsewhere in the world.

So against that commodity price backdrop our business did perform very well. Clearly the cold weather at both ends of the year helped as did a strong operating performance, particularly some good gas production results and a much improved performance from Direct Energy in North America. You can see the Group figures here, revenue up to £22.4 billion. That reflects the higher residential consumption and the higher gas reduction, offset by lower average retail prices both in the UK and in North America. Adjusted operating profit up almost 30% to £2.4 billion with all three main business units well ahead of 2009. I will come back and give you the divisional breakdown in just a second.

The interest charge was up quite significantly, and that reflects the costs we incurred by buying back around half a billion pounds worth of bonds as we look to make the balance sheet more efficient. Tax rate up to 37% reflecting the increase in the proportion of profits coming from the more highly taxed upstream, following the Venture acquisition, albeit that effective rate does reflect some benefit from release of excess provisions as we agreed our tax returns with the Revenue up to and including 2007.

So all that left earnings at £1.3 billion which translates to 25.2 pence per share. And that increase in earnings, together with our confidence in our medium term outlook for the business has enabled us to raise the dividend to 14.3 pence. That is an increase of 12%, well ahead of RPI. Indeed I think you could say that is superior to the RPI of 2% which some of the other companies' target.

So here is the divisional breakdown. You can see immediately the strong contribution from all three business units. I will look at each of them in turn, starting with the UK downstream, British Gas, where profits were up some 20% to £1.2 billion. The main driver within that was of course residential energy. You will remember we led the market down with a price reduction of 7% back in February of last year and that competitive price position, combined with our good service meant we were able to increase customer numbers, adding around a quarter of a million customers in residential energy. So we finished the year with almost 16 million customers.

Average gas consumption was up around 11% per household, reflecting the cold weather at both the beginning and the end of the year. And that led to increased revenue and in the first half enabled us to expand margins as commodity prices remained low. The second half, however, was a quite different picture. We had rising wholesale prices necessitating the retail price increase we put through in December. And as you can see in the top right chart, that squeezed margins down to around 4% compared to the 8.9% that we achieved for the year as a whole.

We continue to drive good growth in services, adding customers in all product categories and increasing the number of installation jobs we did by over 30% with a more competitively priced offering. We did incur some additional costs in services as we negotiated and then implemented the new working practices with the engineers and of course we did have higher callouts during the colder weather. And those together did squeeze our margins a little bit, but with the higher revenue base we were still able to increase profits to £241 million.

British Gas Business had another very strong year. We continue to focus on customers where we can add significant value, moving away from the higher volume, lower margin business. That did mean that combined with average lower prices the revenue base reduced, but we were able to expand margins as you can see from the bottom right chart, and come in with profits up over 25% to £233 million.

Moving to the upstream. Here the results of course include the first full year contributions from the Venture acquisition and the British Energy investment. And as a result, profits up almost 50% to £771 million. Within that we had a very good gas and oil production performance as you can see. That obviously reflects the acquisition of Venture and the addition of their assets to the portfolio. But also a very strong operating performance from Morecambe.

On the other hand, bottom left there, you see realised gas prices were down as commodity prices fell, particularly in the first half. And that was only partly offset by the higher average oil price that we realised. That did mean that although volumes were up 40% profits were up just 30% to £581 million. The power segment now includes our 20% share of the operating profit of British Energy and that is what accounts for the increase in profit over 2009. Our nuclear output was actually somewhat disappointing given the outage at Sizewell, but still contributed 9.7 terawatt hours as you can see. Our own CCGTs generated 22.8 terawatt hours, slightly down on '09 reflecting the lower spark spreads and lower load factors that resulted from that. However with optimisation, we were able to realise spark spreads of over £11 despite those lower average market prices.

And finally within Centrica Energy, the I&C segment, the £36 million there, that will be the final loss from that segment. Most of the main contracts have ended and what is left in I&C we will fold into the gas and power segments for 2011.

Storage had another good year with profits largely unchanged at £169 million. We did actually have slightly lower average SBU prices, but we were able to cover that with better optimisation. However, as you know summer/winter differentials have narrowed considerably and we are looking at much lower SBU prices for the coming storage year and as a result, profits from this business are likely to half in 2011.

In North America Direct Energy had a very good year. You will remember we had some one offs in last year's result. But even if you strip those out, profits up almost 10% to £234 million. That £234 million was despite a loss in the upstream, £46 million loss, which reflects the low commodity prices which hit our Canadian upstream gas profits and also resulted in losses from the CCGTs and the wind contracts in Texas. The strong performance in Direct Energy was on the supply side, both residential and business. Residential customer numbers were actually slightly down, but falling commodity prices meant that we were able to expand margins at the same time as reducing prices. And without the bad debt write-off that we suffered in '09, profits came in at £177 million.

We continue to expand in the B2B market, particularly in electricity supply. And as you can see from the bottom left, despite lower average prices we actually increased revenue and more than doubled operating profit to £88 million.

Services within North America were slightly down in terms of profit. We had transaction integration costs within Clockwork which meant that is yet to have any significant impact on the figures. However the integration has gone well and we will be looking for a significant step up in contribution from direct energy services this year.

In terms of the cashflow, cash generation remains strong. EBITDA now well over £3 billion. We did have a working capital outflow as prices and cold weather towards the end of the year pushed up working capital, but that was more than offset by a margin cash inflow. Capex was at a more normal £1.7 billion, just under, and I will come back and give you a breakdown of that in a second. And that left net debt at £3.3 billion.

Here is the breakdown of the Capex numbers. And as you can see upstream UK is the most significant element. Within 2010 we had three main projects, Seven Seas, Chiswick and F3-FA. We are looking at another increase in Capex within upstream this year as we start three new major projects - York, Rhyl and Ensign.

For power, 2010 includes the final payments on the new CCGT at Langage, it also includes our share of the Capex on the new Lincs Wind farm. In 2011 for power, Lincs will be the biggest single item and we will also continue to spend on nuclear new build ahead of the final investment decision expected next year.

The acquisitions in 2010, the £600 million you see down at the bottom there, include the additional stake we took in Statfjord bought from Shell, the investment made in Trinidad and our two North American acquisitions, Wildcat Hills for the upstream and Clockwork for services.

The Balance Sheet remains strong, net debt to EBITDA of around 1.1 times. That gives us the ability to fund the Capex programme that I just outlined for 2011, and to continue to invest in the business beyond that. We have used our strong cash position, together with the increased availability of bank facilities, to finance that half a billion bond buyback I referred to earlier, as well as improving our debt structure, making it more efficient. That has also improved our maturity profile as most of the bonds we bought back had been due to mature in 2012 and 2013.

We put £300 million of deficit payments into the pension fund and together with some favourable movements in equity prices relative to bonds, that has enabled us to reduce the deficit as mentioned, for accounting purposes under IAS19 at least, to less than £250 million.

We did suffer a number of exceptional items in 2010 mainly due to the low gas and power prices in North America and also the low spark spreads in the UK. We wrote down the existing gas fields we owned in Alberta before the Wildcat Hills acquisition, made a further provision against the Texas Wind Farm contracts and wrote down three of the older CCGTs in the UK.

In summary then, a strong performance in 2010 both operationally and financially, with all three main business units contributing to the profit improvement. Looking to 2011, it will be more challenging for the downstream business without the benefit of the exceptional cold weather we had last year, and with a higher wholesale price to contend with. The upstream will see rising unit costs, but it will of course benefit from those higher commodity prices and we are looking for a better output performance from nuclear and from wind. But also we are looking for growth from services and from North America whereas storage will be down to the lower seasonable spreads as I said earlier.

Overall we are comfortable with where market expectations are right now, around 27 pence per share, recognising that it is still early in the year and we do operate in competitive markets. We do continue to invest in the business with an increase in organic Capex planned for this year. We will see some benefit in the 2011 results from that, albeit quite a lot of the investment is in medium and longer term projects which position the business for future growth.

And with that I will hand you over to Sam.

Chief Executive's Review
Sam Laidlaw - Chief Executive

Thank you very much Nick and good morning everybody. As you have heard, 2010 was a strong year for Centrica. We achieved a significant increase in earnings, up 16% year-on-year and operating profit grew in all of our businesses. Downstream we added over half a million customer accounts, having taken the lead on reducing prices and also on the quality and flexibility of the services we offer. Upstream the enlarged business performed well with strong production volumes and excellent drilling success. And in North America we have made encouraging progress, particularly in energy supply through a combination of improved operational performance and selected acquisitions.

With our distinctive combination of strong cashflows and a programme of carefully targeted investments, Centrica is well placed to deliver further growth.

We have made real and measurable progress across each of our strategic priorities that we announced a year ago. First our priority to grow British Gas. In residential energy we led the market by cutting prices last February, however rising wholesale prices and non commodity costs from the second quarter of 2010 onwards required us to increase our prices, although we were able to hold off doing so until December. To offset the effect of higher prices, we have made it a priority to help customers manage their energy use. Underlying gas consumption has reduced by more than 20% over the last five years and we are actively helping customers to make further savings, for example, through better insulation and by installing more efficient boilers. We achieved a further market improvement in our residential net promoter score and we also retained first place in the Morgan Stanley Energy Supply Survey.

Over the course of the year we added 267,000 residential energy accounts, reflecting both our competitive prices and high service levels. We have also increased the number of customers who take both an energy and a services product, up by 121,000 over the year. And earlier this year British Gas became the new energy partner in the Nectar Energy Loyalty Programme. We also entered into a partnership with Sainsbury's Energy, providing us with a new channel for growth. In the first few weeks since its launch over 750,000 have registered on Nectar and the initial interest in the Sainsbury's energy partnership has been encouraging.

We are also making real progress in our services business. And this is an area of competitive advantage for British Gas. Over time we expect that services will play a defining role for the energy company of the future, forming the basis of long-term sustainable growth. In total we added over 265,000 services customer accounts over the year with growth in each of our core products. And particularly encouraging growth in central heating contracts towards the end of the year. In addition, over 6 million of our services accounts are now on an insurance based product.

We also reached agreement with our engineers on working arrangements which has allowed us to improve the flexibility of the service that we offer and meet the challenge of the very cold weather in December. These new working patterns, together with the steps we took to prepare for winter, enabled us to reach up to 35,000 customers a day during the exceptionally cold weather. That is around double the number for a typical winter's day.

We also increased the number of new boiler installations by more than 30%, mainly as a result of more competitive pricing. And we remain confident that delivering substantial growth in the contribution from the services business with our improved same day service, better productivity and lower supply chain costs. But we face a tough economic climate so it may take a little bit longer to achieve the growth than previously envisaged.

Our strategy is to continue to focus on the quality of the services we offer, our ability to reach customers quickly with a proven distribution network and a trusted engineer workforce. With attractive customer propositions and the capability to undertake the work efficiently, we are well placed to deliver further growth in a competitive market.

British Gas business also continues to perform very strongly. Operating profits have increased by 25% on average over each of the past five years in BGB reaching over £230 million in 2010. Margins have improved to around 8% reflecting the success of our volume to value segmental growth strategy which has seen us move away from high consuming, single site industrial uses to focus on our SME and multi-site customer base where our retail skills can give us a significant competitive advantage.

We continue to deliver a high level of service at competitive prices. As a result customer retention remains high. And in business services we significantly increased the scale of our activities with the Connaught Gas and Electricity Services transaction. This brought us a workforce of over 400 engineers together with more than 20,000 customer accounts. And we are now developing a complete services offering to business energy customers.

In new energy, we remain committed to leading the industry in energy efficiency and we have adopted a go early strategy aimed at revolutionising energy use in the nation's homes. We have now installed over 250,000 smart meters. And we have also launched market leading propositions that enable our customers to take advantage of the latest technology. We have also made a number of small acquisitions in new technologies, including micro generation, specialist insulation, and home energy management. In the social housing sector, we have won the Scottish Government Energy Assistance Programme. And we have also been awarded the contract to run the Welsh Assembly's new programme. And we have entered into a commercial arrangement with Mears to bid jointly on repair and maintenance contracts in this important sector.

Next our priority to deliver value from our growing upstream business. Upstream gas and oil had an excellent year. The acquisition of Venture has transformed the business. The integration went well, staff retention remains high and we now have real depth of expertise as a leading operator in the UK, Norway, the Netherlands and Trinidad and Tobago. Total production volumes were up 43% year-on-year, reflecting strong asset performance and higher production volumes from Morecambe.

And in our drilling programme, 11 out of the 15 wells showed positive results. Together with the Trinidad and Statfjord acquisitions which we completed during the year, our reported reserves increased by 9%. That is equivalent to replacing over 160% of our production. And we plan to drill at least 11 wells this year maintaining our position as one of the most active drillers in the North Sea.

We have also bought 23 LNG cargoes to the UK, up from 15 the previous year. And the agreement we announced yesterday of a three year LNG contract with Qatargas, will create a unique strategic relationship with the world's number one LNG exporter. The contract will provide enough gas to meet around 10% of the total UK residential demand or 25% of British Gas's requirements delivered to the Isle of Grain facility.

And we also have approved this morning the development of the York and Ensign gas fields investing around £450 million, over half of which will be in 2011. These developments offer attractive returns and we estimate that they will add over 30 million barrels of reserves.

In addition, we continue to look for opportunities to increase our reserves through acquisitions where we can add value. The chart shows our upstream gas and oil production profile. As our existing production declines, ongoing investment and development will be required to maintain production at around a 300 bcf per annum level. You can see the significant contribution from Statfjord with its long stable production profile. Included within the core and in-flight section shown in orange on the chart are fields already in development or planned for development within the next three years. These include Cygnus which in detailed engineering and also Ensign and York. These developments will form an important part of our future development plans.

In power generation we achieved strong reliability across our CCGT and wind portfolios. Our new gas fired power station at Langage is performing well, having entered full commercial operation last March. Nuclear contributed over half of the power generation operating profit in 2010. The business is well placed to benefit from higher power prices as part of a balanced portfolio of low carbon generation assets. And we were pleased to secure the five year life extensions for Hartlepool and Heysham which extends their accounting lives to 2019.

Work continues on new nuclear build. Subject to the outcome of consultation over electricity market reform, we expect to make our final investment decision on Hinkley Point in 2012. In offshore wind, all major contracts have been awarded on the Lincs project and onshore works have begun and offshore construction will commence next month.

In gas storage, Rough once again delivered excellent operational performance. The exceptionally cold weather saw the net reservoir volume hit a new low last March followed by record injection season over the summer and unusually high levels of demand in the final quarter of 2010. Despite these high levels of demand, the winter/summer price spread has narrowed significantly which will affect Rough's profitability in 2011. As we announced last year, our Caythorpe project remains on hold at the present time. Work however continues on Baird with a final investment decision later this year.

We have made encouraging progress towards our third strategic priority, to build an integrated North American business. Our downstream performance here has been particularly strong, delivering double digit returns on capital employed, although upstream our profitability continues to be adversely affected by low wholesale commodity prices. In residential energy supply we have improved customer retention and cut the level of bad debt in Texas. We have also successfully launched an innovative prepayment offering using our experience from the UK market. And we continue to enter new competitive markets in the US North East which is an attractive source of growth for direct energy. We maintain our focus on the most valuable segments of market and as a result we saw the attrition of low value customers in the first half of last year. However we have been increasing our customer base in the North East adding 90,000 customers in Pennsylvania and Maryland. And in Ontario the market environment has become more difficult with the Energy Consumer Protection Act impacting both customer acquisition and retention. However we continue to see solid returns from our Alberta business.

In North America the Business Energy Division has had a very strong year achieving an improvement in sales activity and power volumes. We focused on the most attractive segments, improved our service and tightened our cost control. As a result the business achieved a substantial improvement in net promoter score and higher margins which improved to over 3%. The business is therefore well placed for continued organic growth.

In services in North America, the integration of Clockwork is progressing well. The transaction was completed in July making Direct Energy the market leader in the home energy services market to provide a platform for growth through Clockwork's established franchise model. Upstream low gas and power prices significantly affected the returns from the business. However we have continued to look for investment opportunities where we can add value. And the Wildcat Hills acquisition enabled us to add over 240 bcf of reserves at an attractive price and at lower unit cost than our existing gas production. The transaction also improves the vertical integration in the business so that Direct Energy is now able to meet around 35% of our customers gas demand from our own production. Overall we have made real progress in North America as we move towards our ambition of doubling the contribution from this business. North America represents an important opportunity for growth, competing for capital alongside the other investment opportunities available across the Group.

So in summary, Centrica has achieved substantial growth in 2010 making good progress in each part of the business. We delivered strong operational performance, continue to improve our service levels and our safety record, which has been an area of continued focus. As a result we have delivered a strong financial performance with operating profit up by 29% and EPS up 16% on the year. And we have therefore proposed a 12% increase in the full year dividend for 2010, reflecting the significant increase in earnings. We expect to achieve continued growth in 2011. Market conditions remain competitive, particularly in the UK downstream energy supply. However, we are well positioned for growth across much of the rest of the Group. We have an investment programme for 2011 of some £1.5 billion, over two thirds of which we expect to direct towards our UK gas and power upstream businesses. But we remain alert for value enhancing acquisitions and carefully targeted investments both upstream and downstream where there is an appropriate fit with our portfolio.

Centrica is distinctive with its balanced business model which is able to perform well in both high and low commodity price environments with strong organic cashflows, a robust Balance Sheet and a range of attractive investment options.

So with that let me hand over to questions. Thank you.

Sir Roger Carr

Very good Sam, thank you. As always with questions, if you could say who you are and where you are from. We have got the full team here as you know, on the front row. So Sam and Nick will lead on the answers and I am sure parcel out the difficult questions to the team as is the normal way. We also have two non-executive directors here today, but they are not looking to answer many questions.

So if we could start the first question please.

Questions and Answers

Q1. Ajay Patel, UBS

Hello, Ajay Patel at UBS. Three questions if I can. Firstly for 2011. Could you give us guidance for volumes on the upstream both Morecambe and non Morecambe if possible. Secondly, on North America and Residential Energy, I just wanted your thoughts around how sustainable the 7% margin is or is there room for improvement? Any colour there would be nice. And then lastly, are you comfortable with your current capital structure or will you look to further ways to improve it, maybe via further buybacks of debt? Thanks.

Answer: Sam Laidlaw

Well Ajay why don't I take the first one which is around production volumes for 2011. As you saw, we produced just over 50 million barrels equivalent in 2010. We would expect, and that was a result of Morecambe operating at very high levels. We do have some maintenance planned for Morecambe this year, so overall our production numbers will be about 5% lower this year. But still very much in line with our 50 million barrels a year long term guidance we give. In terms of the split, a little bit under a million therms of that will come from Morecambe.

So the second question I think was around margins in North America. We continue to take costs out of the business and obviously we had good margins in Texas. We also, I think, had much better debt collection in Texas. We are installing pre-payment meters. But I will let Chris Weston also just give you some colour commentary between the North East and Texas margins.

Answer: Chris Weston

As Sam said, we do have improved operations in Texas which has allowed us to expand the margins this year both in terms of debt and reducing the operating costs. We have been slightly fortunate in the way the commodity price has stayed low throughout the year, but I am confident we will see the margin remain where it is at the moment. North East margins are slightly lower, but that is a growing business. We are investing more in cost of acquisition to grow it very quickly. I would expect the margins there to expand slightly, but overall I think within residential around 7% is about right.

Sam Laidlaw
I will let Nick deal with the third question which was around capital structure

Further answer: Nick Luff
Thanks Ajay. Obviously the Balance Sheet remains strong as we said, net debt to EBITDA will go around 1.1 times. And clearly everything we are doing we will measure against the benchmark of returning cash to shareholders. Equally I think we do see a big investment opportunity. I appreciate some projects have moved to the right, but you saw the step up in organic Capex for the upstream business. I think we will continue to see bulk on our acquisition opportunities in North America and in the North Sea. So I think we are comfortable with where it is at the moment, but we will keep it under review as we go forward.

Sam Laidlaw
Mark just wanted to add a supplementary I think.

Further answer: Mark Hanafin
I'd just like to add a comment to Sam's on Morecambe. Sam mentioned Morecambe production this year around a billion therms. And obviously you will be looking at something like a 35% reduction from last year and thinking that is a very big number. I would just like to give some background to that. 2008 if you remember we, sorry 2009, we rested the field for broadly half of the year, recharged the pressure, produced in 2010 at exceptionally high levels and really didn't have a shut down. I think we were shut down for three days. So the combination of resting the field, not shutting down, having a major shut down this year, that is what is behind that big change in number. The decline of the field is still in the normal range that you would expect for a North Sea field in the sort of 15% range, the underlying trend.

Q2. Nick Hyslop – RBC
Nick Hyslop from RBC Capital Markets. On the services side Sam, you said that you thought there would be a delay. And you had previously spoken about doubling the profitability there on a three year view, this is from memory. And I am just wondering if there is a competitive change there, given there has been the odd deal in that sector? And then secondly, whether there are any other factors that are causing that to move out, and whether you could put a new timeline on achieving that doubling of profits?

Answer: Sam Laidlaw
Yeah I mean we are certainly not signalling a big change in 2011 but we are saying that for 2012 it might take us a little bit longer to get to that target. And that is in part because two things occurred in 2010. We spent a lot of time I think working on a new agreement with the unions which we now have very good support for and therefore we if you like started this growth trajectory a bit later and we also had the cold weather which meant that we were doing a lot of boiler repairs and so we started a little bit further behind. But you know this is as I say, 2011 we still see strong growth. We still see good growth in 2012, but we might not get quite to that number in 2012, but we will get there a few months later.

Further question
And there are no legislative changes?

Answer: Sam Laidlaw

No, no legislative changes and I think you mentioned competition. We are seeing more competition in the marketplace undoubtedly. But I think we have a premium proposition with the in-day service that we can now offer and our promise to customers that if they call us before 1 o'clock to get there in the same day. And we have done a lot not only with the workforce, but also with the supply chain to actually reduce costs and ensure that the parts are delivered on time. So I think we are not seeing any regulatory threat in that area and actually the fact that we have moved to an insurance product means that actually we also have a higher standard both of selling to go through in that we are FSA registered for that business and I think that is something that we are proud of.

Further answer: Nick Luff
I would add to that, that we indicated £1.3 billion of operating profit in British Gas in 2012 and we have achieved £1.2 billion in 2010 of course and we are still comfortable with that as an overall objective. Clearly the precise mix, you know British Gas business as you saw was doing extremely well and we are looking for good growth there. So I think we are still comfortable with the overall shape of British Gas and some of the mix, things may change.

Q3. Lakis Athanasiou Evolution Securities
A few questions. Just on weather normalisation. Could you give an indication of what the unit consumptions would have been under normal weather for gas and for electricity and BGR? And also along that line, could you give us an indication of how much higher your wind production would have been if you had achieved a P50 type production level for your existing assets? In BGB could you give us an indication of the margin improvement, how much of that is in the mix and how much is related to volume?

And also a couple of questions on strategy. In your nuclear, clearly with the consultation suggesting fixed prices, I mean that is firmly outside of your strategic remit and I am just wondering what your thinking now is on nuclear development and how you sit within that essentially on power generation that will achieve fixed prices if we go that route?

And also on the Qatar deal, three years probably NBP related rate, but clearly you guys would want a longer term. How do you think the Qatari's will be set up for that ongoing and what would be preventing them doing something like that say 10 year PPA now?

And just on Trinidad, your reserves you put in at about 170, 266 at the announcement. Is there something about production, could you put a bit of colour on that please?

Sir Roger Carr
That is about 7 questions, we will try and work our way through Sam?

Answer: Sam Laidlaw
If we could go back to the first one which was I think as I understood it, what would consumption have been with normal weather? I mean I think the point is obviously gas consumption was up 11%. I think it is very hard to honestly tell because I think we have seen such unusual weather patterns in 2010 and whilst we have done a lot of work, and I mentioned it in my remarks, showing that over the last five years there has been a reduction of some 20% in gas demand, I actually think that you can't take

5% off last year, because I think actually normalised. Well normalised weather would have been higher than that, but Phil if you want to comment on it?

Further Answer: Phil Bentley

Well I mean on Elec, it was probably 2-3% and on gas probably 4% maybe something like that on an underlying, but as Sam said it was very extreme weather. You asked a question about BGB. I mean most of that is permanent margin improvement, it largely comes from ensuring we capture the margin that we actually think we are writing. One of the issues we had was we would sell a piece of business at a fixed price and not be quite as tight on the hedging and locking in the margin, and we have worked quite hard to improve margin capture nowadays. So I would say that is the permanent feature of the way we run the business.

Further question

8% a good number going forward?

Answer: Phil Bentley

I mean there was a bit of weather in that as well probably.

Sam Laidlaw:

Your second question, Nick and I interpreted it differently, was it, were you seeking to normalise for wind or for gas production?

Question:

No, wind production.

Answer: Nick Luff

So the load factor was 29% in 2010 and if you take the mix of on shore and off shore we have got, more like 35% in a normal year.

Answer: Sam Laidlaw

And then I think you had a strategic question around new nuclear and the electricity market reform. Our position on this is, you are absolutely right, but one of the options on the table is a contract for difference which amounts to some extent to a fixed price. But we think there is another way of getting there which actually would also be good for new nuclear which would be through a premium feed-in tariff which would be a similar sort of mechanism to ROCs, in that it would still leave investors with the exposure of obviously a construction cost, but also the base power price, but there would be an agreed supplementary tariff. And we think that that in many respects preserves the competitive market and therefore has the distinct advantage. And we also think that actually it probably is going to encourage more competition, but if we are unable to agree what the level of the premium feed-in tariff should be, and therefore because people have very divergent views about future gas prices and power prices, then actually you gravitate back to the pragmatic solution which is the contract for difference. So we are not, we are religious about this, it is essentially what will give us a good return for getting new nuclear going. And we have been very clear all along in our partnership with EDF and with the Government, that actually unless we have satisfactory returns from new nuclear then it is not an investment that we can make.

Further question

Could you see yourselves selling your position basically return to Capex position once the deal has been fixed with the Government if it goes fixed and still retain the same PPA? Just so effectively it could fund or something like that?

Answer: Sam Laidlaw
Well I think if you have a contract for difference then clearly you have a fixed price and that is something that is easily securitisable if you want it to be so at that stage.

I think you had a Trinidad and Tobago question. You had a question around the Qatar contract. I think it is in the nature and actually if you look at the history of negotiations by other counterparties with the Qatari's, quite understandably you know they want to start with a short-term deal and make sure that it all works and iron it out before they turn it into a longer-term deal. But clearly the intention on both sides is to turn this into a longer-term transaction. And how we price it remains to be seen on what the market conditions are at the time.

I think the question on Trinidad was around the reserves that we announced when we made the initial acquisition and you are right, those were the entire net reserves and the reserves that we are reporting in the annual report and in the statements today, are actually net entitlement reserves. So they are reduced for the fact that some of that gas will actually go to the Government.

Further question
So it is not a write-down or anything like that?

Answer: Sam Laidlaw
It is not a write-down for numbers no.

Q4. Ed Reid JPM Cazenove
I'm afraid I have only got two questions. The first question is on the price rise, whether that had an impact on British Gas Residential and how much that was? And secondly throughout your presentation you mentioned that the UK retail energy market is highly competitive, OFGEM are doing a review of the energy market. I read a number of press comments saying there is likely to be referral to the CC. I was just wondering how you kind of reconciled those two things?

Answer: Sam Laidlaw
I think in terms of the price rise which happened on 10 December, I think a number of price rises were happening around the same time. Ours was not the first. We did as a result of that, I think, see a slight increase in churn, but during the month of December, because of the very cold weather we also and I suspect our competitors also saw lower sales because people were unable to get out and sell quite the same amount. So I think with where we have seen January actually, we have seen a modest impact on our overall customer numbers, but we haven't yet seen the potential benefit that we expect to see from Nectar and from the Sainsbury's deal. And we haven't seen the benefit of the fact that we are now back being from the 2 March, the cheapest on electricity and the cheapest on dual fuel and we are the cheapest on online. So I think that will obviously have a positive impact going forwards.

I think in terms of the Competition Commission or prospect of it, let me give you some context here. We have obviously had a number of investigations over the year from OFGEM and we had a probe as you know 18 months ago which was very detailed. I think that came out with some clear recommendations. We are fully compliant with all of those recommendations. I think it is not cleared at all, the industry is, and therefore I think quite understandably, OFGEM have launched this further investigation to ensure that everybody is compliant particularly on areas such as doorstep selling where we have the technology to give all our sales force a tablet and ensure that the price propositions are accurate, not just to the customer, but right down to the street level, that our bills are actually totally transparent and our annual statements which have won awards from Which and Consumer Focus are accurate and our financial reporting is transparent. Now it is not obvious that everybody in the Industry is in that position and therefore quite rightly OFGEM want to deal with it. The last resort is clearly an option, is to go to Competition Commission, but it is in our view, it lets fix the things that are imperfect in this market rather than having a root and branch review which we think would be damaging for investor confidence at the time we are going through the electricity market reform and we actually need to get new power stations built and new sources of gas coming into the country. So our clear position on this is let's focus on what is broken rather than a 2-3 year, and all the advice is that actually a CC inquiry has never been done in less than 20 months. And in an industry such as this which is complex, it would probably be a three year process. And we think that is unnecessary and we would be a mistake at this stage. If it happens, so be it. We are ready to handle it, but I think it is not what the industry needs at the moment.

Further answer: Sir Roger Carr
We have nothing to fear at all, but we are certainly not recommending it is a good idea for the company and for the industry, just to be clear on the message.

Q5. Ashley Thomas, MF Global
Ashley Thomas from MF Global. The £170 million of out of the money contract provisions that you have charged in 2010, can you give me a rough feel of how they benefit 2011, 2012, is it broadly half/half?

And then secondly, could you help my understanding as to why the provisions increase in the second half compared to the first half, given obviously the forward curve, the wholesale price actually increased over that period?

Answer: Nick Luff
The split is roughly two thirds/one third 2011/2012. And I think the way we would characterise it is a benefit to our input costs. And I think you shouldn't assume that is going to flow straight through to the bottom line. It just allows us to have a lower cost base. And therefore be relatively more competitive on pricing.

In terms of why the agreement went up, was we closed out some more contracts so we had some gas we bought at relatively high prices some time ago that was in the portfolio. We closed out some of those in the first half. We closed out more in the second.

Further Question
Just in terms of my understanding, if they were uneconomic in the first half, wouldn't they have been more uneconomic in the first half?

Answer: Nick Luff
We closed them out and so paid the cash cost up front. It is not a cost provision, it is a cash cost closing out those contracts.

Further Question
So just discretionary?

Answer: Nick Luff
Yes

Q6. Martin Brough: Deutsche Bank
Just two questions on the residential side or the British Gas side overall. The first around bad debt just to get an idea of what levels you are seeing in 2010? What are your expectations for 2011/12 as you begin to get interest rate tightening and obviously measures coming through on the fiscal side from the Government?

And the second side around the 'Green Deal' smart meters, is there any more visibility in terms of the financing of that? The infrastructure providers out there that are willing to come in and fund either the meters or things like solid wall insulation? How is the legal framework going in terms of the bill that is going through at the moment, in terms of the loan scheme and potentially finding buyers to securitise bonds and that kind of thing?

Comment: Sam Laidlaw
Your first question, I will let Phil handle both of these. I mean the bottom line of the bad debt situation. On residential we are not seeing deteriorate, probably because a lot of our customers are now on direct debit and a lot of our customers are on pre-payment meters. But Phil.

Answer: Phil Bentley
Yeah it varies between 1-1.5% something like that, 1-2%. It has been falling largely again from self help. As Sam said, we have now moved a number of customers onto direct debit, now at 56% whereas two years ago it was 46%. So things like Energy Smart where you put your own reading in and things that, we have got what we call DD Flex where the customer can take a short holiday to help manage their payments within a 12 month period, that is all driving forward on improving cash collection.

In BGB we are seeing an underlying trend increase in bad debt and insolvencies still. But again if we catch it soon enough as we are doing with new systems, which we have been putting in, we are still seeing a reduction net in bad debt. The 'Green Deal' and smart meters is obviously very interesting for us because it could potentially be a huge opportunity for growth in the servicing business and we are leading with the install installation of smart meters and we have said we will do what we call, 'go early' on Green Deal. What we mean is we will do the financing ourselves of the install in the customers home and collect that money, if you like, on our balance sheet before we securitise, before there is an asset class to be securitised. We will do that this year. I think we would expect by the end of this year that we will have good clarity from DECC on what is in the package. I think there is a sense of solid wall in some shape or form, brought into a solid wall insulator, which looks like quite a good business to me. And I think there will be clarity around how the financing is actually going to work, where does the risk lie? What default rates are we expecting and does it stay with a supplier or with the investor? So still work to be done, but my sense is that we are making quite good progress.

Q7. Mark Freshney, Credit Suisse
Hi it's Mark Freshney from Credit Suisse. Just three very quick questions. Firstly, given the turmoil we are seeing in the Middle East and North Africa, what are you seeing on the physical supplies of gas point? And are you tempted to accelerate some of your hedging in the downstream businesses in response to that?
Just secondly, given the movement in the reported IFRS accounting deficit for pensions, I know you have got I think a 3-4 year deal with the Pension Fund Trustees. Does that deal with the Pension Fund Trustees still stand?

And just thirdly, on Caythorpe versus Bains, given that Caythorpe is much further ahead in terms of the feed studies and so forth, having been carried out, why is it that Caythorpe is on the back burner and you are still looking towards assessing Bains for FID in the second half of this year?

Answer: Sam Laidlaw
Well let me start with the one around are we seeing differences in the supply market as a result of the tensions in the Middle East and Gas supply market? The answer is we are not. Clearly the gas that is oil linked that goes to Asia, the LNG that goes to Asia, will clearly be over time as those indexes work through that will result in higher cost gas. But is hasn't yet had an impact on UK spot market. If there are significant supply disruptions in Southern Europe, then it may work through into the supply stock market, but that has not yet happened and obviously that is something we look at and it is one of the things we take into consideration in our hedging programme, but I don't think we can go further than that.

In terms of your second question which was around the movement of pensions, yes we have got a lower deficit, but actually we are coming to the end and Nick might mention, we are coming to the end of payments we are making.

Further answer : Nick Luff
Yes as you say, the last valuation was at March '09 and that had a three year significant deficit payment and then an agreement after that. We have actually paid all, the first three years, we paid all of the deficit payments now pretty much apart from a few single digit million and that is our choice, because with the tax rates coming down, it made more sense to pay it early. The next valuation is at March 2012 so it is a little way off and then we will have a new agreement depending on what the deficit is at the time. We would caution that Trustees, the way they look at pension deficits does not always align with IAS19 so you may get a different outcome to the ones I have done for the accounting numbers.

Further answer : Sam Laidlaw
I think your third one Mark was around Caythorpe and Bains. In that yes you are right, yes we have put the Caythorpe project on hold. The two projects are very different. The Caythorpe project basically is short cycle time, small onshore project, where we put the gas in and out of the ground at a relatively rapid rate and is designed to take advantage of short-term volatility in gas prices and where the levels of gas prices and volatilities as we have seen this year, we have on our future modelling, we didn't see a satisfactory return on that project. The Baird project which we are still moving ahead with, at the moment, we are still in engineering for, actually requires winter/summer differentials. It is more analogous to the Rough project we already have. Now that too, as a result of compressed winter/summer differentials is by no means certain that that project will proceed, but we are continuing to do the engineering to get the costs as low as they can. I think much will depend on the shape of the forward market going forward.

Further question
What kind of summer/winter spread would you need for that Bains project to be economic?

Answer: Sam Laidlaw
Well I think that is a matter which competitively sensitive. It is not the only project going that is out there at the moment, but higher spreads than we are seeing today.

Q8. Andrew Mead, Goldman Sachs

It's Andrew Mead from Goldman Sachs. I had two questions. One on the Capex. So beyond 2011, given the projects you now also added to the list, what is the outlook for the Capex going forward beyond 2011?

And the second question is a very simple one, just on the North American upstream gas. If it is not making any money why doesn't the volume come down in terms of production? Is there inflexibility in the contract in turning the gas off?

Answer: Sam Laidlaw

I will let Nick talk to the guidance on the Capex and I will talk about North American gas and also let Chris add to it too.

Answer: Nick Luff

So giving the guidance for 2011 at £1.5 billion of organic Capex and that is good for the next 2-3 years, obviously depending any one year on precise timing of big projects. If you remember back to the capital markets, the guidance we were showing was above that. But that very much depends on the storage projects at Baird in particular. So depending on whether they go ahead or not, we could be above the £1.5 billion, but £1.5 billion is still a good number ex-storage.

Further answer: Sam Laidlaw

And I think in terms of North American gas production, the Wildcat Hills gas production that we have added is lower cost base than our legacy gas production if you like. On an, even at low gas prices, on a cash basis our gas production is making good money on a full cycle basis to cover the full depreciation. At current prices it is around break even, but on a cash basis it is still strongly positive. And if we look forward at the futures market, which has got a little bit of contango in it, not much, then actually it is a positive income operation. Chris do you want to add to that?

Further answer: Chris Weston

Just to add to that. We did make a profit this year in upstream gas with a small contribution from Wildcat Hills. We should make a profit next year as well because of the costs we enjoy from Wildcat Hills will improve the cost position overall. Some assets within the portfolio won't, the higher costs, but overall we expect to make a profit even in a depressed market.

Further answer: Sam Laidlaw

And you are on a good point. It is a make or buy position in the sense that if you can turn wells off easily and turn them back on you would, but for some of these older wells, actually you know getting them restarted again is not that simple. It is not like Morecambe in that respect.

Q9. Peter Atherton, Citigroup

It's Peter Atherton from Citigroup, a couple of questions please. Can you run through the cost pressures particularly in British Gas that you are looking at, networks, the various Government environmentally driven charges and tariffs and your internal costs?

And then secondly on this underlying reduction in gas consumption in the residential sector, 3-4% in the last few years. At what point does that put serious pressures on the value of the residential business as an industry and how as an industry are you going to cope with that? Are you going to see to get much higher margins structurally over time? Or is it going to be a question of gaining market share to keep absolute profit levels up? And when do you hit that position? Is it the middle of the decade as the ‘Green Deal’ hopefully in Government terms really kicks in?

And then finally could you run through what your return on Group capital numbers look like over the last 12 months, where you see them trending over the next few years?

Answer: Sam Laidlaw
Clearly if you look at the British Gas cost base, we continue to take costs out of business and you know that is a positive story, but equally we are funding future growth and Phil if you just want to talk a little bit about those two moving parts. Because we have got two areas of significant investment if you like for the whole smart metering world, but also we have a big systems programme to actually enable us to basically take costs out of the business and cross sell between the energy and services side.

Answer: Phil Bentley
I am not sure quite what guidance you are looking for in terms of the future. Clearly you know you saw in the electricity transmission charges this time were up 16% on much smaller volume growth. So that is the effect of the price control, the last price control review now working through. We have got a new gas control review. The last one was quite positive and kept prices down and therefore we haven’t seen that increase. Do I think that the control review in gas will push prices up? Yes I think we do. As we expect the CERT and CESP and what is now called ECO, the new Energy Company Obligation, I think all are going to drive up costs. Now traditionally we expect and have proven we can recover that from our customers as part of an ongoing operating cost at a gross margin level. What we have got to do is get our own internal costs down and we have been doing that. We do think there is more to come. If I take online for example, two years ago we were doing two million online transactions. We are probably doing nearer 18 million this year. Last week we had 900,000 separate contacts on our website. So that is really starting to take off and drive sales up. And the more we can do with that, the more we can keep our own costs down. I think as Sam said, we have got some quite big changes to come through this year on systems, particularly with joining up service systems with energy. As you know we have probably not invested enough on the services side in the past, but we are now ready to invest there and that should drive cross serve, cross deal and drive cross sell. And that is why I think we are still optimistic about our growth in joint customer numbers.

Further question:
And is that investment going to be Opex or Capex numbers?

Answer: Phil Bentley
It comes through in opex in the main. You depreciate the systems fairly quickly.

Further answer: Sam Laidlaw
That is a large part of our investment and we are two thirds of the way through that investment.

I think your question around reducing demand over time, and can we compensate for that as a result of reducing our opex along the lines we have discussed as a result of increasing cross sale, increasing customer numbers? The answer is absolutely, that is the plan.

Further Answer: Nick Luff

And the last question on return on capital. I mean obviously the Group as a whole today is, very high, over 20% post tax. Clearly that reflects the mix of business with the downstream which does not have much capital employed against a smaller upstream business which is growing, does include, the option does include Morecambe which is in the books at low value and therefore high return. So over time that will come down because we are investing more into the upstream and clearly the mix and balance of the business is shifting more towards the capital intensive parts of the business.

Q10. Yohann Terry - Exane BNP Paribas

Two questions please. First question on UK gas prices. You seem to be pretty bullish on the global gas demand in yesterday's press release about the Qatar deal. What is your view on the price role for the UK?

And second question, you didn't provide any view on the conservative expectations for 2011, you did it last year. Why is that? Aren't you comfortable with this level?

Answer: Sam Laidlaw

I didn't hear the second one but Nick did, so that is okay. Let me deal with the first one which is our view on UK gas prices. I mean it is, this clearly has always been a very volatile market. I think many people were surprised by how much the gas price increased in the second quarter of 2010. I think it would be a mistake given the volatility of market conditions and what is going on in the Middle East and everything else to give predictions at this stage. I think the big point for us is the business is much better balanced and if we have rising gas prices upstream is able to benefit from that. If we have falling gas prices, then actually we should be able to grow market share. So I think we now have a much stronger business and we are not going to forecast gas prices, I think that would be an error.

Further Answer: Nick Luff

I think the second question was on expectations for 2011. I think as we said in the statement and I said during the presentation, we are comfortable with where the market expectations are right now which is around 27 pence per share. It is early in the year clearly and competitive market. And within that there is clearly pressure on the downstream business without the very cold weather and with rising wholesale prices. Against that, the upstream would benefit from those rising prices. We are looking for growth out of services and North America. Storage we have touched on today, explaining how we expect profits there to half in 2011, but overall happy with the 27 pence a share but it is early in the year.

Q11. Jamie Tunnicliffe, Redburn

Just coming back to Baird again. I can't remember, I think you might have said in the past that you were engaging with the Government, is that right? And if there would be any change in the way large offshore gas things could be done to make investment in that a more supportive project. Is that right or not? Do you expect anything from that because it is quite an important thing to improve security?

Answer: Sam Laidlaw

I think at the moment, I think it is premature to expect any change in legislation or whatever to support gas storage. I think everybody is focused at the moment Jamie on electricity market reform. And we need to get that forward moving through the legislative process and that is absolutely the priority to ensure that we have good levels of securities of supply, good reserve margins in electricity for the second part of this decade. And I think actually when you look at how we just got through an extremely cold winter, and you know we did have big levels of depletion as the slide showed in Rough, but nevertheless the fact that we have got more LNG coming into the country and LNG is becoming increasingly important, I think demonstrates that whilst we would, we do need to have more storage, we probably have got a little bit of time on this and what we are really focusing on doing with Baird is to re-engineer the costs and actually reduce the costs as low as we possibly can to ensure that we really have a fit for purpose facility there. And if when we have done all of that and when we look at the winter/summer differentials and the market going forwards and we do all our modelling and analysis and we still can't make the numbers work, then we will need to have some serious engagement. But we are not at that point yet.

Q12. John Musk, Nomura

It's John Musk from Nomura. Can I ask a strategic question based around EMR. There are predictions under EMR that up to about 70% of generation is going to be under some sort of feed-in tariff. Under that model, what is the benefit of having an integrated generation if they are not really acting as a hedge for one and other? And if, I think some of your competitors are perhaps already looking at this issue and other issues in their own businesses and there are suggestions of people exiting the UK, would you look to acquire any of those businesses and how do you balance the mix between upstream and downstream under EMR?

Answer: Sam Laidlaw

Well I think the first point is obviously we hope EMR moves forward as quickly as possible so that we can get new nuclear build so we can get more offshore wind built. But this is a very long-term gradual shift that is going to occur and I think the numbers are actually lower than 70%. But whatever the number ends up being, we are not going to get there until the year 2025, probably 2030. So this is you know a very long-term gradual transition that is going to occur. I still think that actually when you look at Mark might like to comment on this, but when you actually look at the analysis as to how much electricity is still going to be competitively priced, and it is still going to be a very large chunk of it, and therefore the integrated model will continue to have good benefit. Mark do you want to?

Answer: Mark Hanafin

Well I think you are absolutely right Sam, it is a very gradual process. If you chart a prediction of what is market priced electricity versus something that is more a feed-in tariff over the next ten years, it is quite a small proportion. So I don't think it immediately challenges the business model. But as Sam said, we have a slight preference for the premium feed-in tariff, it preserves the wholesale market, but implementation is as important as theory in this. And we need to be practical as we work on it.

Closing Comments: Sir Roger Carr

So we still see a long life ahead. Any more questions this morning? Then that concludes the session. Thank you all very much for coming.

End of Presentation