CENTRICA - interim results

An interview with Phillip Bentley, Group Finance Director

Interim results

Q.

These results look good despite the recent concerns we've seen in the market towards the energy sector and Centrica in particular. Will they do enough to boost confidence?

A.

Yes I think they will. I mean we were up in earnings terms 25 per cent net and in operating profit 43 per cent. So that’s a good set of numbers. We've raised our dividend by 17 per cent and[there's] broad growth across all our businesses. So yes, I think we’re very pleased with the numbers.

Q.

And what should investors focus on in terms of the profit mix in these numbers?

A.

I think the growth from our acquisitions has been good. I think the stability and defensiveness of our core British Gas and the AA results looks strong. And I think, overall, the business is in good shape.

UK Energy

Q.

In the UK Energy Supply business you have raised gas prices, which has boosted margins. How sustainable is this 8 per cent operating margin in residential gas?

A.

We've always said that the industry should earn about a 5 per cent margin and we charge a premium in gas. So we’re up now to 8 per cent and that’s up from 2 per cent the year before. So I think that is where the British Gas brand margin should be and so obviously we’re pleased that we’re there and we think it’s sustainable.

Q.

Your focus in the UK appears to be on margins and value creation rather than on customer numbers. Is that the case?

A.

It always has been and we don’t focus on customer numbers for customer numbers' sake. The customer numbers for us define the size of the business that we’re trying to build. But value is what drives our decision-making.

Q.

Electricity margins have improved as wholesale prices have fallen. How sustainable is this level of improvement?

A.

For us, our electricity margins are up slightly. In fact if you look at our gross margins they're up strongly. Our gross margin profit for electricity is £163m. So strong underlying gross margins. We’re still building a business, we’re spending money acquiring customers and we do charge a discount to our competitors. So, yes, competitive margins are slightly higher than ours today but we are pricing at a discount to them.

Q.

The acquisition of Electricity Direct positions you as the third largest supplier in the UK of commercial electricity. What's the thinking behind expanding in that direction?

A.

We believe that busy business managers do not want to be dealing with lots of different utility providers and so our research has said that if we can bundle electricity with gas services, with telephony and then perhaps later fleet management financial services, that's the bundled product that those sort of customers are interested in. So we have been strong in gas in the past and now we've built some scale in electricity. We brought Enron Direct just before Christmas and now we've brought Electricity Direct, giving us a 26 per cent market share. So we're poised in a strong position, we think, to get real growth from that business and as we build from that strength of that base we'll also bring in what we call our scalability, controlling our cost base as we grow our turnover, that flows through to our bottom line. So we have good expectations for that business.

Procurement and upstream operations

Q.

Do the gas import deals that you've done with Gasunie and Statoil signify a move away from purchasing gas field assets?

A.

Not really. Firstly, they are long-term contracts. We haven't actually started shipping the gas and indeed in one of those deals the pipeline hasn't been built, so there is some way to go. But what these are, these are deals that allow us to be assured that we will have the gas supply we need. They don't replace our equity gas. What they're actually doing is replacing other long-term contracts that we had for gas. The big difference, though, is that in the past our long-term contracts were linked to the price of oil. These contracts are linked to the price of gas. So we'll have a much closer linkage with market gas prices through the contracts that we have.

Q.

So is there any risk that you'll get tied into these long-term contracts and not be able to have the flexibility to react to changes in the market place?

A.

No, because these will only provide 30 per cent of our needs. We look to have our own gas to provide some 25 per cent of our needs and we have other contracts as well. We buy from the spot market. One of the things that's happened in the results this time, is that we've turned down the production from Morecambe Bay because we could buy gas from the market very cheaply. Spot prices were very low. We bought from the market, saved our production for later. That's the inherent flexibility that we have in our portfolio.

Q.

But you have recently also been able to buy electricity generation capacity at pretty favourable rates, but maybe not as much as some people would have expected. Don't you need to hedge now?

A.

We now have 1.7 gigawatts of power, which meets over 20 per cent of our needs. We have the Spalding Power Station coming on in 2004, that's another .8 of a gigawatt. Yes, we look for where we see other assets that we can create value from and it's no secret that there are a number of power stations on the block at the moment and we're looking at them.

Q.

Your energy trading arm has been brought into the post Enron spotlight. So what kind of risk exposure do you have through Accord?

A.

We've been very up front about the way we run Accord. The first point is that Accord is there to procure the gas and power needs of our business, to underpin the customer offerings that we have. At the margin, we do trade around those requirements to meet our customer needs and that's what Accord Trading does. We traded profitably in the first six months – a £15m profit. We went through in the interim statement in quite detail how we run the risk parameters around that business. We set a value at risk. That's the amount of money one might expect to lose in an adverse market and we set a target of £21m. We will not lose more than £21m, based on the simulations that we've run. So that restricts the size of the position that we can have at any one time. We have daily mart-to-markets of those positions. We have weekly reports, monthly reviews. The controls around the Accord activity are very, very rigorous indeed and so obviously all these aspersions sort of cast at Accord are disappointing for us. We think it's a well run part of our business and a core part as well.

UK operations: AA, One.Tel and Goldfish

Q.

Doesn't the diversification of UK operations to include the AA, One.Tel and Goldfish, change the risk profile of the company?

A.

I think it does change the risk profile from a portfolio perspective, but we are leveraging the skills that we have. The skills that we have in brand management. The skills that we have in using the data on our customers and the skills that we have in using in our channels to market. So if you take One.Tel, for example. We've been building the brand. We're adding new products and we're now leveraging that database that we have on our customers. So we apply the same skills to those broader brands. Does it change the risk profile? I think the risk is our ability to leverage the skills that we have and we're confident about that.

Q.

But looking at that portfolio of brands, the AA and British Gas seem to be at the core. How committed are you to really developing the other brands in that portfolio?

A.

We've put a lot of money behind Goldfish already. That should be indicative of the commitment, we believe of the value creation for Goldfish. And One.Tel, as I mentioned, we're launching in the second half of the year broadband, mobile and fixed line for One.Tel. New products for that brand. We have signed up deals with MTV and BBC. We are selling our broadband package through Comet. So we're investing in the brand, in the channels with our data.

Q.

And is the negative sentiment we're seeing out there towards telecoms in any way impacting on the ambitions you have?

A.

Nnot really. We're the beneficiary, if you like, of having excess capacity in the market. Our model is as a reseller. We buy capacity from the market and resell to our customers. So the market is over supplied. We buy from the market and you've seen in our results that we've taken advantage of lower carrier prices and increased our gross margin.

Q.

Goldfish has suffered delays due to having to find a new relationship to replace the HFC relationship. There hasn't been that much news about where your expansion plans are there. So what are those plans? What are the targets?

A.

It's true that the HFC litigation process has completely slowed down the Goldfish rollout of products. The big challenge that we have now is the migration of a million credit card customers from HFC to our new banking platform and that is not a trivial exercise as you can imagine. That will take place in the fourth quarter of this year. So because of the delay in moving over the customer base we haven't been layering on lots of new products.

Q.

The AA also has its own independent financial services arm. So what are your ambitions and targets there?

A.

The business has grown strongly. In the last six months the operating profit grew 35 per cent. Insurance sales were up 10 per cent and the loan business has more than doubled. So the business is going well, but there is a lot of potential for the brand. For example, in motor insurance we only have a million customers taking our motor insurance product but nearly 13m AA members. So we think there's a long way to go. So there is a big growth opportunity and by putting together financial services with our roadside for the first time in the AAs recent history we've got one team looking across the business and determining where we can get those cross sales.

North America

Q.

You've been expanding rapidly in North America. Can you make the UK model work in the North American market?

A.

I think North America is pursuing a deregulation process that happened five years ago in the UK. So, obviously, it is further behind as a completely open competitive model. What that means is that there are few markets where both gas and electricity and services can be bundled for the customer. One market where we have that is Ontario where we have 30 per cent of the gas market, 15 per cent now of the electric market and we've now bought the number one services business. So that's the real test of, if you like, the microcosm of the Centrica model and we have strong expectations of great performance from the model. So our consumer research tells us that customers want these bundled products. They want services provided by their utility provider and we think when the markets outside of Ontario also open up fully, then we will have opportunities there as well for the full model. In the meantime single fuel opportunities for gas, for example in Michigan [and] Georgia, we're marketing new programmes there, electricity in Texas opened at the beginning of this year and the Texas market is the equivalent value size for electricity of 80 per cent of the UK. So in one single state we have some quite big opportunities in our view.

Q.

But you've a stated ambition to have 10m customer contracts in North America by the end of 2003. Isn't there also a need to go after long-term value creation as well?

A.

I'd put it round the other way. I mean our first focus is on value creation. When we looked at the New Power deal, which we eventually signed, we had walked away from customers in the original New Power portfolio that we didn't believe would create value. Now we could have taken those customers, they would have destroyed value. We would have returned 250,000 customers in Pennsylvania. There were other customers in the portfolio that in our view were not economic. So value drives all our decision making and always will do.

Q.

You touched on the Texas electricity market. Is there any risk here that regulators could impair your ability to get good margins out of the US?

A.

I think there is and I think that comes back to the point about how mature the deregulation process really is. For example in Texas there is a formula to set the prices that can be charged by incumbents, the so called "price to beat", and there was a flutter in the Public Utility Commission as to whether or not they would allow the formula to apply. In the end they did and so the "price to beat" was raised making sure that we can generate strong gross margin. But each state is deregulating differently. We have to work very hard with the regulators to ensure we have what we would consider to be a level playing field that encourages competition with a sustainable gross margin.

Future investment and disclosure

Q.

The market has for some time considered Centrica to be a growth stock. But there seems to be a hole in investors' understanding of just how much cash you're going to have to invest, business by business, to achieve those ambitions. So can you shed any light on that?

A.

We'd like to think we are both a growth stock, but also have defensive qualities. That was the point we were trying to get over in our results. The AA and British Gas, scale businesses, leading number one positions, give us that defensiveness and generate cash. But at the same time we are growing. Obviously to grow we need to invest. In the main we will be looking at asset acquisitions continuing the theme about hedging in both the UK and North America. There will be some further acquisitions in North America and we will continue to absorb working capital as we grow organically our customer base.

Q.

Companies that are perceived as being complex or difficult to understand are trading at a discount. Are you doing enough in terms of disclosure?

A.

I guess that's the question you have to ask our investors. I think we have tried to respond to some of those concerns. I think we have always believed that transparency is the best way forward when presenting our results. To the extent that we have now newer businesses that need more transparency about their value drivers we provided it in the interims this time. So I would hope if you were to ask me that question in a year's time, then our investors would say that they do understand what's driving the value growth in both the growth features and defensive features of the Centrica businesses.