Centrica AGM Update - 19th May 2006

Phil Bentley: Good morning everyone. As you've seen we've issued a fairly detailed AGM statement this morning. We have the trading update on 16th June and our interim results are on the 27th July so we felt that it was right to give a little bit more detail at this time with the expectation that the trading update can therefore be much shorter and then the results on the 27th July. So we are going to be pretty active in terms of communication over the next couple of months.

The statement flags up that the year to date has been pretty challenging in a number of areas and obviously the first one – wholesale prices - have continued to be an issue for the industry as a whole. Just by way of example, the Q1 gas price for the average month-ahead on a weighted average for the market was 76 pence and that's significantly above last year and above where we expected to be from our own perspective. Obviously our own WACOG is much lower than that because of our hedges and our own production. The higher outturn price in the market was partially due to a number of field outages – we suffered from a field outage early in January from a Shell field - but obviously Rough being out has had an impact on that as well.

And as a result of that, British Gas Residential Energy in particular and our large industrial contracts, both of those areas will be loss making in the first half.

We have put through the price rise. Obviously from March 1st onwards we've moved into profit in British Gas Residential in both March and April, but it was that January and February situation, higher prices, that led to losses in those first two months. But we are trying hard to manage the impact on customer churn: We have launched new propositions. As you see we've been pretty active in terms of marketing. And we've now got over 1400 field sales staff -18 months ago we'd have been down to about 600 - and we've worked very hard to not lose those field staff to competitors and we've done a pretty good job there.
You can see the effect of that; our 2009 fixed price proposition was completely sold out by the end of April so within 8 weeks or so we'd sold over 700,000 accounts. We're now selling that fixed price proposition at a slight premium, on average about 5%, and that's going well as well. And it's good to see that sales have returned to the previous pre-price announcement high levels of over 60,000 gross sales a week.

But we have seen churn obviously on the back of the pricing announcement and then the follow-through in the letters. We've seen that sort of-bow wave of customer losses, but our overall net loss for the period of 350,000 was actually better than we forecast ourselves on the back of the price rise. And now, more recently, we've seen that bow wave dissipate and we're getting back to close to net growth. We've had a couple of weeks of net growth in electricity and on our current estimates now in terms of total energy we ought to get back to net growth overall in the second half. So a reasonably positive outlook on that.

In terms of the migration of our customers to the new billing system, that is going to plan. You'll have seen that we parted ways with Accenture but that's because we've made pretty good progress overall and we're now managing the applications maintenance and final migrations. We've done three large scale migrations. We've got over 6 million customers now on the new system - it's now the largest SAP billing system in the world. We're also adding all our new acquisitions straight onto the new system, and that's over 60,000 a week. So we're pretty confident that we'll complete the migration fully by the second half.

We've also been continuing our focus on reducing costs and increasing our business efficiency. We've started the outsourcing of those back office processes and that's going pretty well in India; over a thousand seats now and we're looking to add more back office processes into those centres. That will deliver some of the benefits this year but, as we flagged before, these benefits will be offset by higher dual running costs, the staff training and the backfilling. So we ought to see overall flat costs in British Gas 2005 to 2006 and then we'll get the bigger reduction in 2007 that we flagged and the overall £200 million savings between the 2004 and the 2007 period.

Upstream we have made some progress in the period. We exercised our pre-emption rights on BP's Statfjord oil and gas field; £152 million - and that is looking good especially when you look at the forward curve today – and that added 65 billion cubic feet of gas and 14 million barrels of oil separately. And we've now got a greater coal exposure with the 600MW of baseload power deal with Drax. Obviously that's a risk management deal; if coal becomes more attractive then that does well, if coal relative to gas is less attractive then the rest of our advantaged CCGT portfolio benefits.

Separately we've pre-qualified in Norway and have opened an office there to participate in this year's exploration licensing round. And we are looking at the UK licensing round that's about to kick off as well; as you know some of that acreage is pretty close to our Morecambe Bay fields in the East Irish Sea.

Talking of Morecambe, obviously you saw our announcement last Friday regarding South Morecambe and our decision to bring forward and extend the normal maintenance period to carry out the remedial work on the cooler units. As we've said they're similar to the cooler units at Rough. We do expect full production back in September. We have bought gas from the market to cover the shortfall in production until the field's back. We're now rescheduling for Quarter 4 and obviously we'd expect in Q4 to produce more than we would otherwise have expected. But overall gas production is going to be down. We had been saying that we would have production down slightly less than 10% in total. With this Morecambe effect that means we will be down around 15% in total. Of that Morecambe now is down more than 20% whereas it would have been down by less than 15%.

I've mentioned Rough; obviously you're getting regular updates from Centrica Storage on the progress there to restoring operations. We're expecting injection to be operational by the 1st June and all the capacity sold to be filled by the end of October, that's the traditional end of the injection season, start of production. When the incident happened the field was fuller than normal in fact because January had been reasonably mild. Now there is an exceptional cost to that outage – £40 million – which will be taken to the middle column in the prelim results.

We still expect Rough to deliver another significant increase in operating profit this year. The consensus is around £185 million and our profit pre- that exceptional charge would be significantly above that such that post- the exceptional charge we'd still be in line with consensus there. And that's because the price of SBUs in 2006 was 62% higher at 56p for the calendar year and we sold quite a bit of that – we've sold all of the 06/07 storage year out and we announced last week that we're selling an additional 11 billion cubic feet of space for that 06/07 year. And at the prices that we've sold on average for that storage year - 67p - that all drops down to the bottom line.

Outside of the UK things are going reasonably well. We've bought a third power station in Texas – $50 million, just over. And that now gives us 1.2GW of power, about a 33% hedge of our business. We added a small acquisition there in terms of customer numbers and we now have over a million customers in Texas and are growing that market well. We touched on growth before in the B2B/I&C market and we've had a very successful first quarter there. And in March we entered the New York market. So overall good progress in North America.

In Europe we are encouraged at last to see the Commission taking real steps to investigate companies over the slow progress towards competition. We're particularly vocal at this time in Belgium as you're aware and it was good to see investigations of both Distrigas and Fluxys, both subsidiaries of Suez, as well as Gaz de France being investigated in those dawn raids. So we are looking for further progress in terms of opening up European activities and we've opened a small office in Düsseldorf to start trading in I&C and trading activities ahead of any downstream market opportunity in Germany that may evolve over time.

We flagged up in February that we had done some restructuring of our upstream operations which would lead to a lower effective group tax rate and you can see in the statement that we've quantified that as being around 4 percentage points reduction. We'll take you through that in a little bit more detail in the half year results, but effectively we've monetised sales from Morecambe Bay. It doesn't affect how we run that business, but it's essentially to a partner whose tax position allows them to share some of their tax benefits with us.

Looking ahead obviously the outlook is still quite challenging. We are benefiting from that retail price rise but the wholesale price rises that we've seen in the market are still a critical factor for the rest of the year, particularly Winter '06. Winter '06 is now 84p; this time last year Winter '06 was 51p, so Winter '06 has gone up 65%. On power, over the same period, Winter '06 is up 53%.

What we're flagging is that at current retail pricing levels - i.e. with no further pricing on our side - and without a material fall in the wholesale price that we're seeing particularly in 4Q, British Gas Residential Energy would be loss making for the year as a whole. We see the price rise and the wholesale market moves as somewhat connected - maybe we'll talk about that in the questions but as of now we're forecasting British Gas Residential Energy, without a further price rise, to be loss making in the year based on our view of the forward curve.

So it has been a difficult start to the year and there have obviously been some one-offs there that have been out of our control. So we are trading below where we would have expected to be at this time at an operating profit level. We'll catch some of that up with the tax planning and at the earnings level will make good progress in those other business. But overall, whilst we're within the range of market expectations for EPS, it is at the lower half of that range – and if you think that the mid point is just over 18p and the min point is 16p, then somewhere between the two is where we'd expect to outturn as we look forward.

At that point now let me hand over to questions if I may and hand back to the operator.

Edmund Reid, Cazenove: I just had a question in terms of the timing on customer losses. The number was slightly higher than I was expecting. I think you've given guidance before that you were pretty much flat in terms of customers ahead of the price rise announcement, is that correct?

Phil Bentley: We were close to it. I think the last time we said we were flat was around week 11/week 12. Obviously we've had a couple of big weeks but as I said it is tailing off quite nicely now and we feel comfortable that we're a long way through the worst.

Edmund Reid: It takes about 4-6 weeks to switch or for the notifications to go through?

Phil Bentley: That's right. The price rise we announced on the 17th February. So you wouldn't have seen any impact on that immediately up to about week 11 and then you start getting the effect coming through. So you've got switching on the announcement, you've got switching on receipt of the letters which went out a couple of weeks later. But now we're in the middle of May, that's pretty much worked through.

Bobby Chada, Morgan Stanley: Just to understand in terms of when you gave your outlook for the year, is that including a loss making Residential Energy Business or is that in the assumption that either you would raise tariffs or wholesale prices would decline? And are you able to give any feel for how the industrial and wholesale contracts might look relative to last year?

Phil Bentley: The guidance we're giving is based on no price rises and our view of the curve. Now as you know our view of the curve still assumes that the gas coming in from BBL and down the Langeled line, plus a reasonable assumption of availability of LNG at Grain, will see prices from here soften a little. So that's the basis of the assumption: no price rise and the Centrica view of the curve. Now the Centrica view of the curve has had to shift upwards from where we were but we can accommodate that without a price rise and give you this guidance. Obviously if the 4Q outturn is a lot higher than Centrica's view of the curve then obviously we wouldn't rule out the pricing lever to compensate that and stay within the guidance we're giving now.

The second part of the question on I&C: we gave guidance north of £300 million at the February prelims results and we're not shifting from that today.

Andrew Wright, UBS: I wonder if you could update us on your view of the position of the various infrastructure projects that are bringing new gas into the UK. In particular could you tell us exactly when you would expect gas to flow under the contracts that you have signed with Statoil and Gasunie and whether you've had discussions with them or indications of whether there's likely to be any delay from that?

Phil Bentley: As you know the contracts that we have with Statoil and Gasunie are delivered at NBP, so whether they flow the gas down the line or whatever, they've got to deliver it at NBP, so the two are not directly connected one to the other. Now obviously it makes it more difficult for them to get the gas if the pipes aren't running. But there is no suggestion of any delays in those contracts and we've not had any discussions with them to that effect. And in fact what we do know is that on the BBL pipeline there have been some discussions about some earlier flow, with linefill and packing gas available a little bit earlier than we might have expected. So I think we feel confident that that gas will be ready to flow and Gasunie feel likewise.

Phillip Green, Merrill Lynch: Just going back to the Rough exceptional charge, just to be absolutely clear, that includes presumably the make-good on repairs post the incident but also does it include effectively the cost to your business of having your own gas effectively trapped within Rough during that period post the incident, particularly through March?

Phil Bentley: It's a good question. The £40 million is the direct cost of repair - we're self-insured up to a level but there is a cost to us of that - and the direct compensation that is paid out to customers for effectively refunding the tariffs that they've paid. It does not include anything for going out and buying the gas because you couldn't get it out of Rough storage. So that's clearly force majeure from our perspective and British Gas is a customer of Rough in that respect and it's got to deal with that itself. So there's no question that the £40 million includes, nor should it, the cost of buying other gas from other sources. No.

John Musk, Lehman Brothers: I just had a quick question - I'm not sure whether you can give us this information – I just wanted to understand how customers were actually leaving and whether it was through direct sales from competitors, through internet switching or through incoming calls.

Phil Bentley: I'm not sure I've got all the information on that. We saw a lot of internet volume early on but that's come right off. We're not seeing any real change in competitor selling activity. What we're seeing funnily enough in terms of customers is this sort of resigned acceptance that prices are going up and therefore if I switch then I may get to find my new supplier charging me more later on as well. So I think there was a sort of initial activity that went on. We're quite successful with our win back activity; we're winning back over about 30% of those people who tell us they're leaving. So I think we're over the worst and hopefully it will start to settle down now.

Peter Atherton, Citigroup: On Rough, has anybody actually challenged the force majeure legally?

Phil Bentley: No, people are all reserving their positions but that's what you would normally do on these occasions. It will work through – I'm told it's something like an 18 month/2 year process. People will reserve their positions undoubtedly but we're pretty confident that – especially now when you look into the HSE real forensic investigation into what caused it, we think it's very much covered by force majeure.

Andrew Mead, Goldman Sachs: Can I just ask a bit about the upstream issues you face? You put out a thing last week about North Morecambe and South Morecambe, South Morecambe in particular, and I understand from that statement that you should have resolved the issues after the four month outage and there shouldn't be therefore any more issues with South Morecambe downtime. Is there any potential for future downtime at North Morecambe? And the second thing was just on Rough – in terms of getting it up and running for next month and this winter, is there still any issue to be resolved in 2007 longer term?

Phil Bentley: North Morecambe, as we've said, that's part of its normal maintenance so that will be back up as normal. South Morecambe, we've accelerated the maintenance; we normally have that field shut in for all of August so effectively we're out now for the balance of May, June and July which is not a time a) when we produce that much gas and b) it's at margins which are generally softer in the year compared to 4Q. So I think we're fairly confident that we'll get those back on track as we flagged up.

On Rough the only issue is that we're effectively having to re-engineer. We used to dry the gas at Rough on the platform and then cool it down and send it back dried. We're re-engineering that at the moment so that we'll dry the gas onshore - that's generally how these things are engineered today anyway. For a time the change in that engineering would mean that some of the backup systems cannot run - if there is a failure in the front line systems the backups will run at a slightly lower capacity for a short period. But other than that, a) there's no expectation of any front line failure having fixed it and b) we'll end up with the backup to full capacity later on.

Andrew Mead: So to be clear you are not expecting any further issues in 2007?

Phil Bentley: Absolutely not and we wouldn't be selling it out if we felt there was.

Ian Mitchell, JP Morgan: Just a very quick question on the tax; obviously good news that you've got the tax rate down. First of all, this year is the majority of the tax reduction down to this restructuring that you've done or how much of the impact is due to lower profitability from the upstream division because production is down? And secondly is this something that you see as being something that you can continue to utilise going forward and therefore maybe reduce the tax rate permanently going forward?

Phil Bentley: The transaction we have has a finite life but it has some years to it. The lower production out of Morecambe, percentage wise which is taxed at a higher rate, will mean that it's slightly down but most of that impact is down to the tax planning not to Morecambe.

Colin Pollock, Credit Suisse: In your statement you mention that in the home services business its costs were higher over the winter. Can you just explain some of the drivers behind that?

Phil Bentley: It was relatively warm to start with and then it got very cold in February and March. Normally we are affected by the weather generally if it's around the turn-on or the turn-off period. But this was unusual in that obviously the systems were on but they were breaking down because they'd been on full and it got particularly cold. So we got a lot more callout volume for repairs, for breakdown. And that's to our cost unfortunately because people have got effectively an insurance contract with us.

So that's the main one. The other side of it is that central heating sales have been slightly softer around the country; both the housing market and also people tend to put in new central heating systems more in the summer than in the height of winter, so they were a little bit softer as well.

It was just an early flag up of that.

Jamie Tunnicliffe, ABN Amro: Just following on that question on British Gas Services; would you expect as a result of that exceptional demand that the sort of margin you can achieve for the full year would be below the sort of underlying margin you delivered in '05?

Phil Bentley: It could be very very marginally on slightly higher turnover - and profitability will be similar or maybe a little bit more but not the same sort of step-up that you saw in '05 - that's the sort of guidance. So if profits are slightly up on '05 but turnover is up more then obviously you'll have a small margin compression.
We're looking at the growth; the new management team have been working hard looking at the growth profile and opportunities there. We think there is a lot of opportunity around what we would call 'on demand'; we think there is a lot more opportunity around what we would call 'smarter pricing'; and we think there's a lot more opportunity around engineer deployment productivity improvement. And the new management team are working hard on all of those. What we're flagging up is you probably won't see that coming through as quickly in '06 because of those higher other costs. But for sure we're expecting quite a big pick-up in '07.

Bobby Chada, Morgan Stanley: I just wondered, you flag working capital in the statement as something that's been moving. I wondered how much you expected working capital to move in the year and if it's significantly different to how you guided it in February?

Phil Bentley: It's not materially different. It could be a little bit more on the back of the higher wholesale prices at the end of the year - that will be the only impact there if 4Q outturns as the forward curve predicts. But the guidance we gave of the £500 million, we're comfortable with at the moment.

Bobby Chada: And that was a £500 million intra-year movement, is that right? So the net year-on-year movement would be less than that or a net year-on-year movement of £500 million?

Phil Bentley: It would be a net year-on-year movement of £500 million.

Iain Turner, Deutsche Bank: Could you just take us through the decision to bring back inside the outsourcing contract with Accenture, and then the timetable going forward here for the finishing off of the implementation of the new system?

Phil Bentley: We've been working closely with Accenture for four years now. And at the same time we've been improving our own capabilities, particularly around SAP functionality. And so rather than outsource ongoing maintenance and release maintenance, we felt that we'd have more control over it if we brought that in-house. Four years ago we wouldn't have had the capability to do that; today we have and therefore we'd rather manage our own destiny in what is our key core system. The fact that we said cheerio to Accenture is indicative, not as some people have interpreted it as there being a problem; it's indicative of the fact that with the progress we've made we don't need them any more. They're still on the hook for warranties but we don't need them to finish off the last transfers and releases.

Iain Turner: And the timetable for finishing it off?

Phil Bentley: We've said second half and we're pretty confident about that.

Edmund Reid, Cazenove: Just on price rises, I think since your price rise most of your competitors have also raised their prices or at least announced price rises. I was just wondering if you could tell me what's the average differential now? I know it's a very hard question because there are lots of different tariffs but just generally?

Phil Bentley: On average it's about 10 or 11% on dual fuel. You may have seen that both Powergen and nPower have said, since their price rises, they think that more price rises are needed this year. So I think we're all in the pack here. We're at a dual fuel premium of just over 10%.

Operator: You have no further questions at this time.

Phil Bentley: Okay, well thanks again guys. Hopefully the discussion next month will be a little bit shorter. We'd like to say at the trading update "no new news" but we will speak to you then if there is anything different. Cheers, bye-bye.