Message From Management

Right: Kunio Anzai
Chairman

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President

Mega-competition is knocking at the door of Japan's energy sector. And deregulation is unlocking it. This movement is being further accelerated by the worldwide information technology revolution. Gas and electricity companies are entering each other's fields. Even companies from other industries are announcing their arrival. We welcome this new era. With "deregulation" and "change" comes "opportunity." Bring it on. We believe we have what it takes to seize the opportunities and grow. That was our message last year—and it hasn't changed. If anything, we're more convinced than ever that we have what it takes to drive growth. In November 1999, we released a new medium-term management plan covering fiscal 2000, the year ending March 31, 2001, through fiscal 2004. In this message, and throughout this report, we will explain how we aim to accomplish our goals over the next five years and beyond.

The Year in Review

Consolidated net income for fiscal 1999, the year ended March 31, 2000, increased 50.3% year on year to ¥26.6 billion. As a result, return on assets (ROA) improved from 1.0% to 1.5%.

Gas sales volume in the Tokyo Gas Group increased 3.2% from a year ago. Gas sales in monetary terms, however, were down ¥2.9 billion at ¥672.0 billion due to two main factors: reduction in gas rates based on the gas cost adjustment rate system, and implementation of a downward rate revision in December 1999. Consequently, consolidated net sales declined 0.6% to ¥992.2 billion. Operating income also decreased, down 4.2% to ¥69.2 billion. An improvement in other income (expenses) and the effect of a reduction in Japan's statutory tax rate, however, led to growth of net income.

Deregulation

Major strides were made in energy sector deregulation in fiscal 1999.

In the Japanese gas industry, revisions to the Gas Utility Industry Law were enacted in November 1999. Those revisions lowered the threshold at which regulations on gas supply areas and rate-setting were removed for large-volume customers—from those consuming 2 million cubic meters or more per year to 1 million or more. In addition, the process for reducing gas rates was simplified. Companies can now lower rates simply by filing a report with the Ministry of International Trade and Industry (MITI). Previously, it was necessary to navigate a complex system to obtain permission. Furthermore, we gained more management independence. Gas companies are now free to use part of their profits from business activities to strengthen their balance sheets and return profits to shareholders, rather than solely for the reduction of gas rates as in the past.

In the electricity industry, revisions to the Electricity Utility Industry Law in March 2000 opened the door to liberalized electricity sales to large-volume customers, defined as users with a capacity of over 2,000 kW and using a 20 kV supply or more.

We view the advancing deregulation in both the gas and electric utility industries positively. As mentioned in the opening of this letter, deregulation is creating new and exciting business opportunities. Natural gas, which is environmentally friendly and for which there are stable supply sources, is the cornerstone of our strategy to seize these opportunities. By promoting its advantages, we will fortify our position in the greater Tokyo market and transform Tokyo Gas into a diversified energy services company. That means we will supply heat and electricity, as well as gas. Gas-fired cogeneration systems, which provide electricity and thermal energy, will be a core driver of growth.

What Are Tokyo Gas' Competitive Advantages?

We believe the following core strengths will give us a competitive edge amid intensifying competition in the energy sector.

1. Natural gas, our core product, beats other energy sources hands down in terms of its minimal environmental impact and energy efficiency.
2. A powerful and reliable network—connecting a broad base of customers exceeding 8.7 million in total—with an enhanced supply capability ready to meet growing future demand with minimum additional investment.
3. Strong marketing capabilities backed up by engineering expertise and price competitiveness.
4. The technological competency to meet market needs.

By leveraging these strengths to the maximum, we will expand existing business domains and advance into new ones, including electricity retailing.

Medium-Term Management Plan Offers Blueprint for Success

The medium-term management plan we formulated in November last year is grounded on these strengths. This plan aims to maximize corporate value and thereby earn us high marks from customers, shareholders and other stakeholders. To this effect, we will increase free cash flows—net income plus depreciation expenses less capital expenditures—and improve asset efficiency.

Maximizing Free Cash Flows to Maximize Corporate Value

We have set increasing free cash flows as a yardstick by which we will measure our success at creating corporate value. By implementing measures to streamline management and increase gas sales volume by enhancing our competitiveness,

Profitability and Financial Position Improvement Targets

[Non-Consolidated]	March 31, 2000	March 31, 2005
Net sales	¥869.9 billion	¥1,020 billion (Average growth rate of 3.2%)
Total assets	¥1,493.6 billion	¥1,440 billion
Interest-bearing debt	¥761.9 billion	¥610 billion
Equity ratio	29.7%	39.0%
	March 31, 2000	5-Year Average (Year ending March 31, 2001 through year ending March 31, 2005)
Free cash flows	¥26.0 billion	¥50 billion (5-year total: ¥250 billion)
ROA	1.5%	1.9%
Total asset turnover	0.60 times	0.65 times
[Consolidated]	March 31, 2000	March 31, 2005
Net sales	¥992.2 billion	¥1,170 billion (Average growth rate of 3.3%)
	March 31, 2000	5-Year Average (Year ending March 31, 2001 through year ending March 31, 2005)
Free cash flows	¥42.0 billion	¥61.5 billion (5-year total: ¥307.5 billion)
ROA	1.5%	1.7%
Consolidated net income to non-consolidated net income	1.19 times	1.13 times

we aim to achieve non-consolidated free cash flows totaling ¥250 billion, an average of ¥50 billion per year, over the 5-year period from fiscal 2000 through fiscal 2004. Free cash flows in fiscal 1999, by comparison, were ¥26 billion.

These free cash flows are to be earmarked for reducing interest-bearing debt, returning value to shareholders either by repurchasing and retiring treasury stock and/or increasing dividends and investing in new businesses.

Regarding interest-bearing debt, we increased debt over a number of years to finance the construction of core facilities to meet predicted expansion in demand. As of March 31, 2000, this debt stood at just over ¥760 billion, representing approximately 50% of total assets. Tapping the additional free cash flows we expect to generate, we plan to bring interest-bearing debt down to ¥610 billion by the year ending March 31, 2005.

Improving Asset Efficiency

A little under 10% of our total assets of roughly ¥1.5 trillion as of March 31, 2000, will be accounted for by production and supply facilities that are presently under construction and will help us to meet higher demand in the future. When these facilities come on line and demand increases, we will start recovering these investments. By working to improve our top line and earnings at the same time as reducing total assets and using existing assets more effectively, we intend to raise ROA and total asset turnover. Specifically, our goal is to raise ROA to an average of 1.9% from 1.5% in fiscal 1999 over the 5-year period from fiscal 2000 through fiscal 2004; total asset turnover will be raised from 0.60 times in fiscal 1999 to 0.65 times over the same period.

Achievement of these goals will call for greater management efficiency to strengthen operations, and rate reductions and organizational reforms to bolster our competitiveness. Here's what we intend to do in this regard.

Driving Efficiency

Personnel Reductions

We plan to lower our head count at the parent company to 10,000 people by the end of fiscal 2005. We will accomplish this personnel reduction through organizational reforms, systematization, retooling of administrative processes and fostering staff potential to reduce personnel. Putting limitations on new recruitment is also part of our strategy.

Controlling Operating Expenses

We plan to hold operating expenses to the fiscal 1998 level of ¥224.2 billion for the next 3 years. While higher than the ¥215.3 billion in operating expenses recorded in fiscal 1999, reflecting our expectation that fixed expenses will increase in line with steady expansion of our customer base, we aim to keep a lid on operating expenses by implementing streamlining measures.

Internal Financing of Capital Investment

Tokyo Gas is close to putting the finishing touches on several large-scale infrastructure projects. While using existing assets effectively, we aim to keep future capital expenditures on production and supply facilities within the limits of free cash flows in the 5-year period through fiscal 2004. This will be achieved by reviewing construction methods and specifications as well as rationalizing purchasing to find ways to slash costs.

Introduction of a Strategic Management Structure

In July 1999, we reduced the number of divisions and departments by approximately 30%. At the same time, we carried out reforms to put in place a strategic divisional system comprising six divisions aligned in terms of functions and markets. These changes are intended to drive administrative efficiencies. They are also designed to strengthen our marketing capabilities and enhance customer services and safety. Augmenting this new strategic framework is an innovative business management system introduced in April 2000. The new system, in a sense, entails each division and department working like an independent company, and clearly spells out the responsibilities of each section as well as the targets and results that are expected of them.

First of Two Rate Reductions Implemented

Tokyo Gas had announced plans to reduce rates by a total of 4-5% through two reductions. In December 1999, we carried through on that promise, reducing rates by an average of 2%. The second rate reduction, planned for the current fiscal year, will be in the order of 2-3%. The rate reductions are intended to make gas an even more attractive energy alternative.

Expanding Demand by Strengthening Competitiveness

Based on these strategies to bolster our competitiveness, we plan to expand gas sales volume. The most promising area is the gas market for electricity generation, including gas-fired cogeneration, whose share in our gas sales volume is expected to increase from 15% at present to 27% by the year ending in March 2005.

One major supply contract will contribute to the achievement of this target. Starting in fiscal 2001, we plan to supply upwards of 1.0 billion cubic meters of gas per year to The Tokyo Electric Power Company's Shinagawa thermal power station. That equates to about one-tenth of all the gas we supply.

Recent trends are working in our favor. We are seeing a shift from large-scale power generation to distributed power generation and on-site electricity generation. This promises to lead to higher demand for gas from IPPs (independent power producers) and electricity supply in specific areas such as redevelopment zones. Micro turbines will also likely spur gas demand. They have attracted attention in recent times as a major step toward the introduction of cogeneration systems for small-scale, private-sector users. This market has been difficult for gas companies to penetrate until now because of the lack of suitable products. Moreover, recognizing the importance of alliances in this changing business environment, we are conducting feasibility studies with a view to entering the electricity retailing sector ourselves with NTT Facilities and Osaka Gas.

Contributing to Local Communities

One of our greatest assets is our broad base of 8.7 million customers. To enlarge this base we are upgrading customer services and stressing maintenance and improvement of the stability of supply and safety. Furthermore, research and development is being emphasized to respond to diverse customer needs in an aging society which is being fundamentally altered by advances in IT. Information technology is an important area of focus. We are planning to establish, for example, two-way communication with customers via the Internet. Tokyo Gas is also actively involved in environmental issues. Expanding the use of clean-burning natural gas is one example. Moving forward, we intend to promote the use of energy-efficient equipment and systems as well as the reduction of industrial waste volumes and greater recycling. By doing so, we will play our part in contributing to the realization of a sustainable society.

Stepping up Overseas Activities

Overseas activities are taking on greater importance for the Tokyo Gas Group. Heretofore, our four representative offices overseas in New York, Paris, Kuala Lumpur and Beijing have been used mainly for gathering information and for management and technological exchange with foreign energy-related companies and institutions. While continuing these activities, we also intend to use these offices as conduits for disseminating information to investors abroad.

Leveraging our experience and successes in overseas projects, we intend to develop overseas operations. We can point to our joint venture projects in Malaysia in particular to demonstrate our capabilities. These included the construction and operation of a natural gas distribution system. This was the first such overseas project undertaken by a Japanese energy utility company. Gas Malaysia Sdn. Bhd., the joint venture company, started paying dividends in 1999.

Focusing on Consolidated Management

Japanese companies were required to start reporting consolidated financial information starting in the fiscal year ended March 31, 2000. Tokyo Gas, however, has been practicing consolidated management for some time now. In 1993, for example, we reorganized the Tokyo Gas group into 10 business fields, including energy sales, cryogenic energy use and chemicals businesses. One company was established in each field to take the leading role. Their goals were to drive management efficiencies within their fields and grow earnings. In fiscal 1999, we undertook a review of each of our businesses. At the same time, we formulated guidelines for when to withdraw from unprofitable businesses and for when to reduce and consolidate group companies. We intend to clearly delineate the strategic position of each group company to raise the value of the Tokyo Gas Group.

In Conclusion

As deregulation takes hold, we are likely to see more and more entrants into Japan's gas and electricity businesses from both within Japan and overseas as well as from other industries. We are determined, however, to grow as a leading company in this climate of change. We are committed to executing the plan we have formulated to produce the results you expect of us, and to continue to be a major player in the "natural gas era" of the twenty-first century.

July 2000

Kunio Anzai
Chairman

Hideharu Uehara
President