Our Vision

going the distance with total energy solutions

Mitsunori Torihara President

Q: You launched a new medium-term management plan in fiscal 2006. How would you assess initial progress under the plan?

Torihara: Fiscal 2006 was the first year of our medium-term management plan covering the period from fiscal 2006 to fiscal 2010. Various aspects of the business environment changed more than we anticipated when we first announced the plan in January 2006.

First of all, the price trend of crude oil remains in the high range. Though natural gas is becoming more price-competitive relative to other fuels, this factor eroded the ability of gas cogeneration systems to compete with grid-connected electric power systems on price. Another change was an extreme acceleration of the trend toward the use of electricity instead of gas. Rising consumer awareness of the all-electric concept was reflected in increased competition from electricity. There were also some unfortunate situations, including cases of carbon monoxide poisoning caused by water heaters. These had the effect of eroding public confidence in the safety of gas.

We responded to these changes by totally reviewing our policies in the summer of 2006. While making additional investment to reinforce our strategies to counter competition from electricity and achieve strengthened safety measures, we endeavored to reduce costs and continued to respond flexibly to changing conditions.

As a result, I believe that we generally made a good start in terms of our management performance. We set new records for net sales, operating income and net income. The increase in sales resulted mainly from volume growth driven by marketing efforts, combined with higher unit prices under the gas rate adjustment system, which adjusts gas rates according to gas resource costs. Despite dramatically higher gas resource costs and increased expenditure on safety, we were able to keep operating expenses under control through savings in other areas, including reductions in labor costs resulting from further work force downsizing and an actuarial differential on retirement benefits*. Operating income increased by 44.5% to ¥162.3 billion over the previous year.

There was continuing growth in gas sales volumes, especially for industrial use. This reflects the important environmental advantages of natural gas, as well as its price advantage relative to crude oil. Sales to residential and commercial customers stagnated due to mild winter temperatures, but overall there was a 1.7% year-on-year increase to 13.3 billion m^3.

We also achieved encouraging sales of strategic products that we see as important to our efforts to counter competition from companies offering all-electric systems. These include our "Pipitto Konro" gas cooktops, our highly efficient "Eco-JOES" water heaters, and mist saunas. Sales units of these items were substantially higher than the previous year's results.

In the industrial segment, we have started to make steady progress toward our establishment into an integrated energy company, as envisioned in our medium-term management plan. In June 2006, Tokyo Gas Yokosuka Power Co., Ltd. started operation as our second power plant, with power generation capacity of 240 MW, and in April 2008, an 800-MW facility operated by Kawasaki Natural Gas Power Generation will come on line.

* Tokyo Gas calculates its retirement benefit liabilities using actuarial computations based on specific assumptions. Actuarial differentials are all shown as cost items in the accounts for the following year.

Q: Your forecasts for fiscal 2007, the fiscal year ending March 31, 2008, appear pessimistic. What are the reasons for this?

Torihara: While we expect net sales for fiscal 2007 to exceed the excellent result for fiscal 2006, we are predicting a sharp decline in income. The three main factors for this forecast are a heavier cost burden resulting from sharply higher gas resource costs, higher personnel expenses resulting from an actuarial differential on retirement benefits, and aggressive investment in demand development to counter competition from all-electric systems.

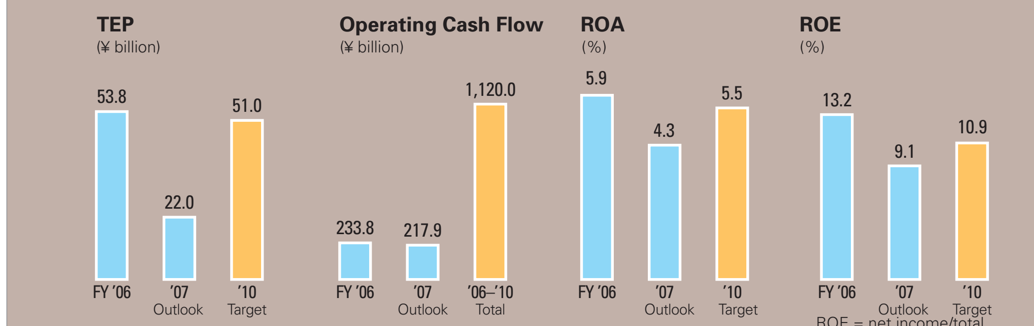
One reason for the rise in gas resource costs is higher LNG prices. This reflects rising world demand for LNG, as well as the instability of crude oil prices, which have started to move higher again after a period of relative calm.

The actuarial differential on retirement benefits has occurred despite cost savings resulting from decreasing our employee numbers and is attributable to external factors. These include a relatively lower yield on pension assets in fiscal 2006, compared with the excellent results achieved in fiscal 2005, and another factor was the effect of a three-yearly actuarial review. In addition, the discount rate has fallen from 2.0% to 1.8%.

Investment in demand development is essential to counter the effects of competition from all-electric systems. We will focus in particular on the expansion of sales of in-house power generation systems, which combine our ECOWILL and LIFUEL systems. We regard these as strategic products. Our target for fiscal 2007 is to install 3,950 units, which is over three times higher than the fiscal 2006 result of 1,304 units sold. In addition to our investment in home power generation products, we are also steadily implementing initiatives that are expected to yield sales growth in the future. These include increased efforts to overcome recent consumer concerns about using gas and appeal the safety and comfort features of gas.

In fiscal 2007, we are also structuring a regionally focused marketing approach as stated in our medium-term management plan for fiscal 2006 to fiscal 2010. Specifically, we plan to establish new regional energy companies to integrate the functions of safety inspections, meter reading and the collection of gas charges, as well as sales and maintenance of gas appliances, that was formerly undertaken by Enesta. These services will be fine-tuned to reflect the diverse lifestyles of our customers. Trial operation of the new scheme has already started in some regions. We are confident that this shift from a function-based marketing structure to a regionally based one will yield sustained benefits through the clear grasping of customer needs while regularly carrying out day-to-day gas-related operations.

Major Management Targets



TEP (Tokyo Gas Economic Profit) = net operating profit after tax prior to interest payments – cost of capital

WACC FY06 Results: 3.8% / FY07 Outlook: 3.8% / FY10 Target: 3.8%

Operating cash flow = net income + depreciation

ROA = net income/total assets (average of positions at start and end of fiscal year)

ROE = net income/total shareholders' equity (average of positions at start and end of fiscal year)

Q: How will changes in the business environment affect the current medium-term plan?

Torihara: In fiscal 2006, many aspects of the business environment changed conspicuously compared with the assumptions on which the medium-term plan was based. However, we took a positive, forward-looking stance in response to these changes and quickly convened internal discussions. Our entire organization is now working to make the necessary adjustments.

One of the issues that has affected us is public concern over carbon monoxide poisoning. We have responded by implementing special inspections of gas appliances. In fiscal 2007 we will deploy an additional 100 service staff and fulfill the scope of our safety inspections. We have also allocated a budget of ¥10 billion for measures to encourage consumers to replace their appliances with safer models. In addition, customer contacts in the course of our business operations provide opportunities to remind customers about the importance of appliance safety. Through the initiatives mentioned here and elsewhere, we do everything possible to restore public confidence in gas as quickly as possible.

LNG prices have climbed in step with rising crude oil prices and are now above the level that we projected when formulating the plan. Our forecast of lower income in fiscal 2007 reflects sharply higher gas resource costs resulting from tight LNG supply and demand balance in the global market, and the high level of crude oil prices. However, we believe that this situation will improve as LNG is delivered from new projects, including Sakhalin Ⅱ in 2008, and Gorgon and Pluto after 2010. In future, we will continually modify our LNG procurements according to prevailing conditions, including the use of flexible contract terms.

Under our medium-term group management plan for fiscal 2006–2010, we aim to increase our presence in the LNG value chain while building Tokyo Gas into an integrated energy company. Though income in fiscal 2007 will be substantially below the fiscal 2006 level, if we exclude external factors, such as the actuarial differential on retirement benefits and an increase in depreciation due to tax revision, our estimates for fiscal 2007 would be in line with the initial forecasts in our medium-term management plan. Our goals remain unchanged. We will work even harder to maintain our reputation as a trusted and preferred energy supplier, by maintaining the reliability of our supply services, competitive pricing, and strong commitment to continual improvement in safety and service quality.

Q: There has been widespread public interest in M&A activities and other events affecting the energy sector in Europe and North America. Do you foresee similar development in Japan? What are your views on M&A?

Torihara: We are closely monitoring energy sector developments in Europe and North America. Of particular interest is a flurry of M&A activity in the European electric power industry, which appears to have resulted from total deregulation of the industry. Moreover, the energy situation in the EU is such that they have developed electric power and gas distribution infrastructure across the region. Investors ask me if a similar situation is likely to develop in Japan. While we cannot rule this out entirely, conditions here are different, and we need to consider the situation calmly.

While the scope of deregulation is expanding in Japan, nationwide electric power and gas distribution has yet to develop sufficiently. The debate over full deregulation, including the residential sector, is only just beginning. Unlike the telecommunications and aviation industries, there are no restrictions on share ownership by foreigners in electric power and gas. However, if a foreign corporation wishes to acquire 10% or more of the shares in a power or gas company in Japan, it is required under the Foreign Exchange and Foreign Trade Law to notify the Ministry of Economy, Trade and Industry to obtain permission. There are other restrictions under the Gas Utility Industry Law and the Antimonopoly Law. For such reasons, it seems unlikely that our industry will undergo rapid restructuring as a result of M&A and similar activities.

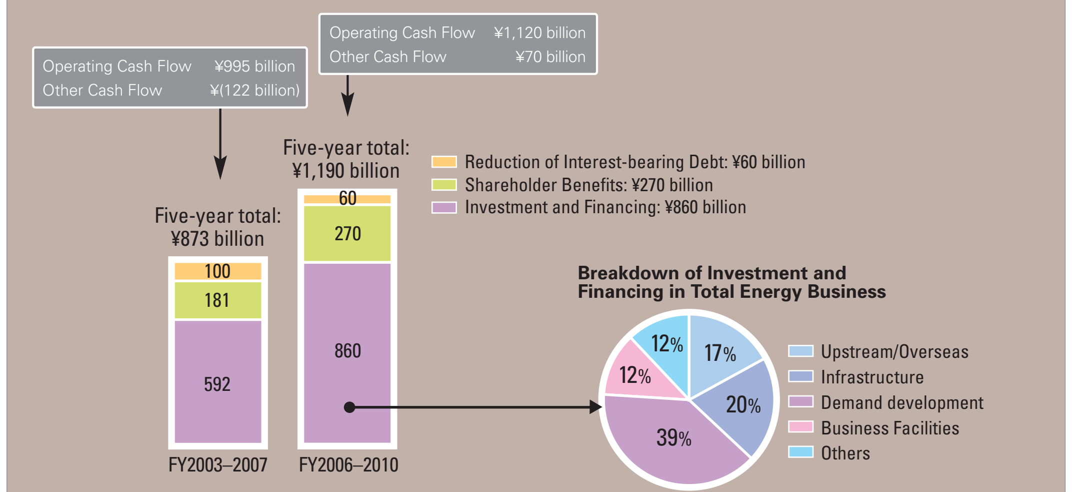
I firmly believe that the priorities for Tokyo Gas are to achieve continual improvement in our corporate value, and to maintain dialogue with the markets as the basis for an appropriate valuation. For this reason, we have not established specific defensive measures against takeover bids. However, we are prepared to take appropriate decisions if there is a risk that large-scale buying of our shares will jeopardize our ability to implement our management philosophy or damage our corporate value. In such an event, we will evaluate the TOB proposal with outside experts, as well as holding a dialogue with the investors. If we conclude that the activity would have a negative effect on our corporate value or the common interests of our shareholders, we will disclose details of the situation to our shareholders and make prompt decisions about the need for specific countermeasures and the content of such measures, so as to be ready to introduce and implement them.

Another question that I am asked is whether Tokyo Gas plans to merge with or absorb other city gas companies. Tokyo Gas is currently a wholesale supplier to 24 city gas companies in its service area. In volume terms, sales to these companies account for over 10% of our total sales, and we anticipate a high growth rate averaging 4.4% over the next five years. We are aggressively developing our wholesale supply business, which allows us to earn income without increasing our assets. We have no plan to engage in hostile M&A activities that might have a negative impact on the business. However, we have taken over the business operations of a government-owned gas business when it was privatized. If there were an optimal M&A deal that would enhance our corporate value and improve customer convenience, we would positively consider it while taking the wishes of the other party into account.

Q: What are your views on shareholder benefits and financial strategies?

Torihara: In our medium-term management plan, we have set targets for operating cash flows and defined our allocation policy. Specifically, we aim to generate operating cash flows of ¥1,120 billion and other cash flows of ¥70 billion, making a total of ¥1,190 billion. Of this, we intend to invest ¥860 billion in the development of our integrated energy business. This medium-term management plan is seen as an important step toward the realization of our long-term strategy for the period beyond 2010, and, consequently, we intend to concentrate our management resources and invest aggressively in our core business.

Basic Policy on Cash Flow Allocation (5 years)



I see our business strategy and financial strategy as two halves of a whole. Together with our integrated energy business, which constitutes the foundation stone of our business strategy, our financial strategy and shareholder benefits are the most important issues for management.

In our medium-term management plan, we have set a 60% target for the total payout ratio*. We have also declared our intention to distribute income to shareholders through dividends and stock repurchases. Based on this total payout ratio concept, we have increased the dividend for fiscal 2006 and beyond by ¥1.0 to ¥8.0 per share, and we have allocated funds to repurchase stocks worth ¥39 billion (60 million shares). As a result of these measures, the total payout ratio for fiscal 2006 is expected to be 60.1%. While maintaining dividend stability, we aim to raise the dividend gradually. We have almost completed our stock repurchases for fiscal 2006, which we implemented to prevent dilution caused by the conversion of convertible bonds. Our priority from now on will be to enhance shareholder value by repurchasing stock primarily with a view to cancellation.

Another management priority is to maintain an appropriate capital structure and capital costs. Our main indicators in this area are ROE and Tokyo Gas Economic Profit (TEP), which is the Tokyo Gas version of Economic Value Added (EVA®). We aim to achieve sustained improvement in all of these indicators.

As president, I am determined to steadily implement the medium-term management plan while also ensuring that Tokyo Gas remains a trusted name and a company of choice for shareholders, investors, customers and the public. This unswerving commitment will continue to guide our activities in a changing business environment as we work to create and develop new markets for natural gas and build a broad-based profit structure for 2010 and beyond. We will go the distance.

*Total payout ratio of year n =
[(dividends from unappropriated profit in year n) +
(amount of treasury stocks acquired in year n + 1)] /
(consolidated net income in year n)

Mitsunori Torihara, President