LEFT: Kunio Anzai
Chairman

RIGHT: Hideharu Uehara
President

Deregulation. Change. Restructuring. Competition. We see in these words a positive connotation for business opportunities. They mean you must do things differently, stretch yourself, improve—tough tasks. But we are up to the challenge. We see opportunities in change. In this message, and throughout this report, we will demonstrate what underlies our confidence and how we will create growth as a gas company in a deregulatory climate. But first let's take a look back at the past fiscal year.

The Year in Review

Consolidated net income for fiscal 1998, the year ended March 31, 1999, was ¥17.8 billion, 3.0% up from a year earlier. We delivered a return on equity of 4.2% compared with 4.1% one year earlier. Cash dividends per share were ¥5.00, the same as in the previous fiscal year.

Net sales fell 1.1% overall to ¥997.8 billion, despite a 2.0% increase in gas sales volume, due to the lowering of gas rates in accordance with the gas cost adjustment rate system. Operating income decreased 5.5% to ¥72.3 billion, mainly due to increased depreciation costs incurred with the startup of the Ohgishima LNG Terminal. However, we achieved a net income increase due to the improvement of non-operating profit.

Deregulation—What it Means for Tokyo Gas

In 1994, the Japanese Gas Utility Industry Law was amended, abolishing regulations governing the areas where companies can supply gas and rates for large-volume customers using 2 million cubic meters or more of gas per year. The deregulation trend was accelerated by the startup of a third-party access system in 1996 and other law amendments that take effect in this autumn to lower the threshold for large-volume customers to 1 million cubic meters per year. The pricing system will also be revised to give more freedom to us in setting pricing strategies.

The electric utility industry is also undergoing change. Amendments to the Electricity Utility Industry Law in April 1995 ushered in a new system that includes independent power producers (IPPs) and power distribution in specific areas. In the fall of this year, retail sales to customers with a capacity of over 2,000 kW and using a 20 kV supply will be liberalized.

Combined with deregulation and restructuring in Japan's petroleum industry, competition in Japan's energy sector is increasing as gas, electric, and oil companies see barriers that have divided their markets torn down.

The flip side of the coin is that deregulation is spawning new opportunities—opportunities for expanding market share. We will continue to devote ourselves to remaining the first choice for customers. Firstly, we intend to secure more large-volume customers both inside and outside our service area with the lowering of usage thresholds and the lifting of restrictions on the supply service areas. Secondly, we will make every effort to make our transmission service to third parties a profitable business. Thirdly, deregulation in the electricity industry will allow us to supply gas to IPPs—and even become one ourselves—as well as to enter the power distribution field in specific areas.

Environmentally Friendly Natural Gas—Another Driver of Growth

Another factor besides deregulation is working to our advantage—big things are expected of environmentally friendly natural gas, our main raw material. COP3, the Third Conference of the Parties to the United Nations Framework Convention on Climate Change, was held in Kyoto in December 1997 to set reduction targets for global warming gas emissions. To achieve Japan's targets, laws to conserve energy and respond to global warming have already taken effect in Japan. We see this as an opportunity to promote natural gas through our R&D efforts and other activities.

How Are We Responding?

Deregulation and new government policies don't only cause change—they also create opportunities. By capitalizing on these opportunities, we aim to capture a greater market share in the Japanese energy sector through restructuring programs and focusing on three core themes: more efficiency, more capacity, and R&D for more demand. Through our efforts, we will implement a rate reduction in fiscal 1999 and 2000 while preserving our profit margins.

More Efficiency

In order to further strengthen the price competitiveness of our products and services, we have set the following goals to become more cost competitive.

*Personnel reductions—*By fiscal 2005, we plan to trim our workforce to 10,000 people, from roughly 12,000 as of the end of March 1999. This is in addition to the 1,000 reduction achieved in the last 4 years.

*Organizational reform—*We have streamlined our organization. We combined our 33 divisions and departments into 24 divisions and departments in June 1999. As for the marketing and customer service organization, we replaced the existing 5 business district divisions with a new structure made up of 4 strategic divisions in accordance with functions and markets. The new divisions are Customer Service, Pipeline and Safety Management, Residential Sales and Service, and Energy Sales and Service. The aim: providing a better response to our markets and customers with enhanced safety and stability of supply.

*Reduce capital expenditures—*We have reviewed our capital expenditures and will reduce our investment in plant and equipment to within the limits of our cash flows by fiscal 2000. Selection of investment projects with stricter standards, more efficient designs, improved procurement management and promotion of technical development will aid these efforts. We will reduce non-consolidated capital expenditures from ¥132 billion in fiscal 1999 to ¥110 billion in fiscal 2001.

*Paring operating expenses—*We intend to hold operating expenses at current levels while increasing sales volumes. This will require more efficient deployment of resources. However, we will continue to invest in strategically important areas including marketing and safety management.

More Capacity

Our powerful supply infrastructure will also play an important role in strengthening our cost competitiveness and meeting increased demand. Two immense projects will result in greater supply capacity. In October 1998, the new, state-of-the-art Ohgishima LNG Terminal started operation. Additionally, in 1999 the Keihin Transmission Pipeline and Yokohama Transmission Pipeline will complete and enhance a supply loop that encompasses the greater Tokyo area. We will thus be able to deliver more gas, more reliably and more efficiently to customers over the greater Tokyo area. We will be able to meet the growing demand in the next few decades with minimum additional investment.

R&D for New Demand

Demand for gas is expected to increase. But we feel we must take the initiative to work even harder at promoting the benefits of gas to create new demand. We must show customers how gas can work for them. Technological innovation is underpinning these efforts. Development of gas cooling systems with higher efficiency and compactness, gas cogeneration systems and floor heating are some of the fruits of R&D that are contributing to sales. We are also developing new technologies in such areas as polymer electrolyte fuel cells and micro gas turbines, as well as making improvements to enhance the stability of supply, raise safety levels and reduce costs. In this drive, we budgeted about ¥14.0 billion for R&D for the current fiscal year.

An Active Presence Overseas

Overseas activities are taking on greater significance at Tokyo Gas. Mainly through our four overseas representative offices, we have been working to collect information and to share management and technology information with overseas energy-related organizations, as well as to promote investor-relation activities.

In Malaysia, we were the first Japanese energy-related utility company to participate in an overseas project. The project, aimed at building a natural gas distribution system, is being successfully carried out by our joint venture, Gas Malaysia Sdn. Bhd. Gas Malaysia started to pay dividends in 1999. Leveraging these successes as well as our expertise in gas-related operations, we intend to assume an active role in overseas energy projects while maintaining the proper balance between profitability and risk.

The Road Ahead

We must not overlook another area for bolstering our competitiveness—building a stronger balance sheet. We will achieve this by using free cash flows from our value creation activities to reduce interest-bearing debt. This debt increased in line with the capital expenditures needed to put in place our production and supply system to meet higher gas demand in the 21st century. With much of this work having already been completed—capital expenditures have passed their peak—we intend to fund future capital expenditures from cash flows from operations.

As deregulation permeates the energy industry, the companies able to meet the demands of the new era will become increasingly apparent. Tokyo Gas aims to be one of them. We are creating more demand for gas by leveraging core competencies and enhancing efficiency and capacity, which will translate into more value for our shareholders.

As a public utility company based in the Tokyo metropolitan area, we have been given the significant responsibility of contributing to the stable supply and use of environmentally friendly natural gas while maintaining a high level of safety. Thus, our management mission is to make contributions to customers and communities as well as to maximize shareholders' value. In all our efforts, we remain steadfast in our commitment to being an active company in a new era of competition in Japan's energy industry.

August 1999

Kunio Anzai
Chairman

Hideharu Uehara
President