Management's Discussion and Analysis

Highlights of the fiscal year ended March 31, 2006

- **Gas sales were stronger than in the previous fiscal year, driven by new demand arising from heightened awareness of environmental issues and relatively cheap gas prices compared with crude oil prices. A colder winter than in the previous fiscal year also contributed to sales growth.**
- **Crude oil prices were high throughout the fiscal year, resulting in higher raw material costs for gas. Osaka Gas strove to absorb these cost increases by reducing personnel costs.**
- **Earnings at consolidated subsidiaries were not as strong as in the previous fiscal year, although results did exceed original expectations.**
- **Among special factors in performance, the settlement of LNG contracts during the fiscal year produced an extraordinary gain.**

As a result of the above, Osaka Gas recorded growth in consolidated sales and profits for the fiscal year under review.

1. Non-consolidated Gas Sales

In fiscal 2006, sales volume of gas to residential customers increased 4.0% year on year to 2,329 million cubic meters. Expanded sales can be attributed to the addition of approximately 60,000 households as new customers, and to a colder winter than in the previous fiscal year.

In the commercial and industrial sectors, we strove to develop new demand. Demand actually increased during the fiscal year under review for various reasons. Because of the hike in crude oil prices, gas was relatively less expensive. There were signs of a recovery in the Osaka regional economy. In addition, the shift to natural gas from other fossil fuels is accelerating amid heightened awareness of environmental protection issues. As a result, sales volume of gas to industrial customers rose 4.8% from the previous fiscal year, to 4,049 million cubic meters.

Furthermore, gas sales volume to commercial customers climbed 3.0% year on year, to 1,071 million cubic meters, while gas sales volume to public offices and medical customers advanced 6.0%, to 641 million cubic meters. In addition to the development of new demand through means including increased installation of gas equipment at hospitals and waste management facilities, a colder winter compared with fiscal 2005 contributed to sales growth. Overall, gas sales volume to commercial and industrial customers totaled 5,761 million cubic meters, an increase of 4.6% from the previous fiscal year.

As a result, on a non-consolidated basis, the Company's gas sales volume rose 4.9% to 8,448 million cubic meters.

Non-consolidated Gas Sales

[45MJ/m^3]			FY2006/3 A	FY2005/3 B	A-B	A/B (%)
Customers [meters installed] (thousand)	Residential		6,437	6,377	+60	100.9
	Commercial/industrial		321	319	+2	100.6
	Total		6,758	6,697	+61	100.9
Average monthly usage per customer (m^3/month)			34.2	33.1	+1.1	103.2
Gas sales (million m^3)	Residential		2,329	2,238	+90	104.0
	Commercial/industrial		5,761	5,509	+252	104.6
		Industrial	4,049	3,865	+184	104.8
		Commercial	1,071	1,039	+31	103.0
		Public and medical institutions	641	605	+36	106.0
	Sales to other gas suppliers		359	305	+53	117.5
	Total		8,448	8,053	+395	104.9
Average temperature (Celsius)			16.9	17.7	–0.8	–

2. Income Analysis

In fiscal 2006, consolidated operating revenues advanced 9.3%, or ¥90.6 billion from the previous fiscal year, to ¥1,065.9 billion. Among the factors contributing to growth in operating revenues were an increase in the volume of gas sold, and a higher sales price based on the fuel cost adjustment system due to the rise in the cost of LNG. Other contributors were business expansion of existing consolidated subsidiaries and an increase in the number of consolidated subsidiaries.

In total consolidated costs and expenses, the cost of sales expanded due to the rise in the volume of gas sold and the increase in gas material costs along with the rise in crude oil prices. However, Osaka Gas continued its efforts to reduce costs throughout its business and endeavored to cut gas supply-related selling, general and administrative costs.

As a result, operating income climbed 4.9% year on year, or ¥4.6 billion, to ¥100.6 billion. Ordinary profits grew 6.0%, or ¥5.8 billion, to ¥103.3 billion, primarily as a result of increased gains on investments in equity-method affiliates. Net income surged 59.2%, or ¥30.0 billion from the previous year, to ¥80.7 billion, boosted by an extraordinary gain of the receipt of the one-time settlement payment upon termination of an LNG handling contract.

Gas Segment

Owing to the development of new demand, increased sales volume due to a colder winter than in fiscal 2005, and higher gas rates compared with last year under the fuel cost adjustment system, operating revenues rose 8.2%, or ¥46.8 billion year on year, to ¥619.7 billion. Despite efforts to reduce costs throughout the business, the increase in gas materials costs along with a surge in crude oil prices resulted in operating income edging down 1.0%, or ¥0.6 billion, to ¥61.8 billion.

LPG, Electricity and Other Energies Segment

Segment revenues jumped 19.7%, or ¥31.1 billion year on year, to ¥189.0 billion due to extraordinary revenues posted by some of the non-consolidated peripheral businesses of Osaka Gas. Although expenses also increased due to the rise in raw material costs, operating income still soared 31.0%, or ¥4.3 billion, to ¥18.5 billion.

Gas Appliances and House-pipe Installation Segment

Operating revenues in this segment advanced 3.7%, or ¥5.5 billion year on year, to ¥155.9 billion due to the substantial sales of large-scale gas appliances, such as cogeneration systems. Operating income soared 89.1%, or ¥2.4 billion, to ¥5.2 billion, bolstered by sales expansion and cost reductions.

Real Estate Segment

Real estate segment operating revenues edged up 1.8%, or ¥0.4 billion from the previous fiscal year, to ¥25.7 billion. Operating income, however, declined 6.7%, or ¥0.4 billion, to ¥6.6 billion.

Others Segment

Others segment operating revenues expanded 9.8%, or ¥12.9 billion year on year, to ¥145.3 billion due to the inclusion of Japan EnviroChemicals in consolidation. Operating income, on the other hand, decreased 3.7%, or ¥0.2 billion, to ¥7.7 billion due to the divestment of Kinrei Co., Ltd.

Fiscal 2006 Operating Revenues and Operating Income by Segment (¥ billion)

	Gas	LPG, Electricity and Other Energies	Gas Appliances and House-pipe Installation	Real Estate	Others	Elimination and Corporate	Consolidated
Operating revenues	619.7	189.0	155.9	25.7	145.3	(69.8)	1,065.9
Year-on-year change (%)	+8.2%	+19.7%	+3.7%	+1.8%	+9.8%		+9.3%
Year-on-year change (amount)	+46.8	+31.1	+5.5	+0.4	+12.9	–6.3	+90.6
Operating income	61.8	18.5	5.2	6.6	7.7	0.7	100.6
Year-on-year change (%)	–1.0%	+31.0%	+89.1%	–6.7%	–3.7%		+4.9%
Year-on-year change (amount)	–0.6	+4.3	+2.4	–0.4	–0.2	–0.7	+4.6

Operating revenues for each segment include internal sales and transfers between segments.

3. Assets, Liabilities and Shareholders' Equity Analysis

Asset Management Policies

The Osaka Gas Group views deregulation in the electricity and gas sectors as a business opportunity and intends to aggressively expand its operations in growth fields, especially electricity, while reducing assets in unprofitable business fields and day-to-day operations. To minimize investment risk caused by changes in the operating environment, Osaka Gas is further tightening its procedures for investment decisions, and subsequent follow-up and evaluation, based on the Group-wide investment criteria applied to individual investment proposals hitherto.

Osaka Gas aims to maximize capital efficiency by targeting a ratio of interest-bearing debt to equity of approximately 1 and a shareholders' equity ratio of more than 40%. In deciding the weighting of third-party capital versus internal capital it will pay due consideration to relative capital costs and the maintenance of a sound financial position. The current shareholders' equity ratio is 44.9%, and Osaka Gas intends to promote business investment in growth fields by raising funds through interest-bearing debt in line with the growth in shareholders' equity as profits increase.

Capital Investment

In fiscal 2006, non-consolidated capital investment totaled ¥75.4 billion. The continuing construction on the Shiga Line—part of the Kinki Trunk Line—remained a major construction project during the fiscal year under review. In addition, capital investment for peripheral facilities increased in relation to the planned construction of an electric power plant inside Osaka Gas's existing Senboku facilities. Consolidated capital investment totaled ¥117.4 billion, expanding from the previous fiscal year due to the building of new LNG carriers.

The Osaka Gas Group is aggressively investing in both domestic and overseas electric power businesses as potential future growth drivers. Investment targets include such upstream operations as natural gas fields and LNG carriers, as well as IPPs and other downstream electric power businesses. The major growth-oriented investment projects to which capital investment was allocated during the fiscal year under review were the Shiga Line, the Senboku Natural Gas Power Plant, and LNG carriers.

Capital Investment (¥ billion)

	FY2005/3	**FY2006/3**
Manufacturing	2.2	**5.4**
Gas supply	36.4	**40.0**
Commercial and industrial	2.9	**3.3**
Peripheral	0.8	**26.6**
Non-consolidated	42.5	**75.4**
Consolidated	65.5	**117.4**

Investments

To proactively develop growth fields, the Company also makes business investments together with its capital investments. During the fiscal year under review, the Company made investments in major growth-oriented investment projects totaling approximately ¥61.0 billion. The investments were distributed as follows: approximately ¥9.0 billion in a Spanish IPP, about ¥15.0 billion in U.S. IPPs, about ¥12.0 billion in Japan EnviroChemicals, and approximately ¥23.0 billion to purchase an interest in a North Sea oil field (through Idemitsu Snorre Oil Development).

Total Assets

At March 31, 2006, consolidated total assets amounted to ¥1,398.6 billion, expanding approximately ¥181.2 billion from the previous fiscal year. The increase can mainly be attributed to an approximately ¥131.5 billion rise in investments and other assets from the previous fiscal year. Of the increase in investments and other assets, investments in growth businesses accounted for ¥61.0 billion, as previously mentioned.

The Osaka Gas Group is in the process of systematically selling its cross-holding investments in securities, particularly in financial institutions. However, in the fiscal year under review, the decrease in investments in securities was offset by the increase in the prices of securities, resulting in an overall rise in investments and other assets.

Interest-bearing Debt

In fiscal 2006, the Company frequently needed to raise funds for capital and other investments under its aggressive growth-oriented investment programs. Since profits were much higher in the fiscal year under review than in recent fiscal years, there was a substantial supply of internally generated funds, but the demand for capital for growth-oriented investments exceeded such internally generated funds. As a result, interest-bearing debt rose ¥38.9 billion, to ¥487.5 billion. Looking at a breakdown of the additional debt, on a non-consolidated basis, the Company redeemed ¥35.0 billion in corporate bonds, while newly issuing ¥20.0 billion in corporate bonds. New issuances by consolidated subsidiaries totaled approximately ¥15.0 billion. Long-term borrowings for the year under review increased by ¥33.1 billion, while short-term borrowings expanded by ¥5.3 billion.

Shareholders' Equity

At March 31, 2006, shareholders' equity amounted to ¥628.5 billion, advancing ¥97.6 billion from the previous fiscal year. At the beginning of the fiscal year, the Company retired the treasury stock it was holding, increasing the amount deducted from shareholders' equity due to treasury stock by ¥39.9 billion, and reducing retained earnings by the same amount. However, the increase in retained earnings from net income exceeded the decrease related to the retirement of treasury stock, resulting in retained earnings rising ¥26.3 billion from fiscal 2005. Among other items contributing to growth in shareholders' equity, net unrealized gains on securities rose, reflecting the increase in the value of other securities.

4. Cash Flow Analysis

In fiscal 2006, net cash provided by operating activities grew ¥36.0 billion from the previous fiscal year, to ¥152.9 billion due mainly to the increase in income before income taxes and minority interests. Net cash used in investing activities rose ¥97.3 billion, to ¥162.9 billion, mainly reflecting increased expenditures for purchase of property, plant and equipment and purchase of investments in subsidiaries and affiliates. Net cash provided by financing activities expanded ¥37.1 billion from the cash outflow recorded in the previous fiscal year, to ¥13.2 billion. This turnaround resulted despite the redemption of corporate bonds during the fiscal year because of the large proceeds from long-term borrowings.

As a result, cash and cash equivalents totaled ¥47.7 billion at March 31, 2006, an increase of ¥3.4 billion from a year earlier.

(¥ billion)

	FY2005/3	**FY2006/3**	Change
Cash flow from operating activities	116.9	**152.9**	36.0
Cash flow from investing activities	(65.6)	**(162.9)**	(97.3)
Cash flow from financing activities	(23.9)	**13.2**	37.1
Increase/decrease in cash and cash equivalents	27.3	**3.4**	(23.8)
Cash and cash equivalents at year-end	44.2	**47.7**	3.4
Interest-bearing debt at year-end	448.5	**487.5**	38.9

Free cash flow: ¥84.2 billion, compared with ¥57.7 billion in fiscal 2005.
Free cash flow = cash flow from operating activities – capital expenditures

5. Quantitative and Qualitative Disclosure of Risk

The following are risks that could affect the business performance or financial position of the Osaka Gas Group. It does not constitute a complete list of the risks that the Group is exposed to.

Risks Faced by the Gas Business

The following are the main factors that could adversely impact the performance of the Osaka Gas Group's core natural gas operations:

❶ Fluctuations in weather and water temperatures on gas demand
Sales volumes of gas can be affected by fluctuations in weather and water temperatures. Therefore, these fluctuations could impact negatively on the performance of the Group.

❷ Impact of foreign exchange and interest rate fluctuations on financing
Fluctuations in foreign exchange and interest rates could affect the performance of the Group. However, the potential impact of fluctuations is limited because the Group hedges foreign exchange rate risk using derivative instruments and the major portion of its debt bears fixed interest rates.

❸ Fluctuations in raw material costs
The price of LNG, the raw material for gas, can be influenced by changes in foreign exchange rates. The effect may be offset by a change in the sales price through the operation of the fuel cost adjustment system. However, depending on the time required for the higher costs to be reflected in price and the composition of raw material procurement, the fluctuation in foreign exchange rates could adversely affect the performance of the Group.

❹ Problems related to raw material procurement
Because LNG, the raw material for gas, is procured overseas, it is possible that problems related to the facilities or operations of the LNG supplier could have a negative impact on the performance of the Group.

❺ Problems related to production and supply
A major natural disaster or accident could disrupt the production or supply of gas, adversely affecting the performance of the Group.

❻ Regulatory reform in the gas industry and resulting intensified competition
Regulatory reforms could further progress through changes in the Gas Utility Industry Law and other laws, regulations, and administrative systems, causing intensified competition in the energy market and impacting negatively on the performance of the Group.

Other Risks

❶ Businesses other than the gas business
The performances of the Osaka Gas Group's other businesses are impacted by conditions in their respective markets. However, the Company is working to minimize such impact by consolidating all its subsidiaries to gain an understanding of how they are being run and draw up prompt measures to deal with any issues.

❷ Managing personal information (privacy policy)
Due to the nature of its business, the Group possesses a great deal of personal information about its customers. Consequently, the Group seeks to thoroughly comply with and to educate and train its employees and service vendors about the law regarding the protection of personal information that was enforced in full commencing April 2005. Nevertheless, should the personal information of customers be leaked outside the Group, the incident could impact negatively on the Group's performance.