DONG Energy's comments on the report of the Danish National Audit Office (Rigsrevisionen)

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At the request of the Danish Public Accounts Committee, Rigsrevisionen has reviewed DONG Energy's business conduct in the period 2007 to the third quarter of 2012. Rigsrevisionen has today published its findings in a report.

It is DONG Energy's impression that Rigsrevisionen has done a thorough job of analysing issues relevant to DONG Energy's overall business.

In its report, Rigsrevisionen attaches importance to the fact that, since the merger in 2006, DONG Energy has been pursuing a strategy designed to realign the company's business model to secure its future revenue base. This has taken the form of investment in building up primarily two new business units, in offshore wind and in oil and gas production. It is against this background that the company's large investments and financial performance should be viewed.

Our detailed comments to the following issues are set out below:
- DONG Energy's earnings and equity ratio
- Financial position under pressure in 2012
- Divestments
- Investments and risk management
- Pay and bonus conditions
- Expenses for management and administration

Earnings capacity and equity ratio

Rigsrevisionen points out that DONG Energy's equity ratio in the period 2007-2011 was satisfactory, but that - apart from 2008 and 2010 - its earnings were not sufficient to secure a "positive direct return" covering the cost of capital. The report states that DONG Energy's earnings, profitability and equity ratio declined substantially in 2012.

DONG Energy is fully aware of these issues. DONG Energy is in the middle of a major transformation of its business that began on the formation of the existing DONG Energy in 2006. Because of the internationalisation of the energy market, Denmark needed a company that could act as driver of the Danish energy sector and hold its own in the competition with the large European energy companies. At the same time, it was clear that earnings from one of the company's major sources of revenue, the DUC gas contracts, would diminish. It subsequently became clear that the company's second core area in terms of earnings - the power stations - would also come under pressure.

To preserve a robust Danish energy company it was necessary to change the company's strategy, with investment in new business areas, especially in offshore wind and oil and gas production. In that connection DONG Energy also developed a very ambitious green strategy that was to convert the company's electricity and heat generation from black to green in the course of a generation.

Since the merger, DONG Energy has made investments totalling more than DKK 80 billion on building up the new business. Most of these investments have been in offshore wind and oil and gas production, and they have been sound investments.

Today, we are in the middle of this transformation. The DUC contracts and the power stations, etc., had to fund the business to a great extent until the new investments started making money for the company. However, in 2012, Energy Markets, which is part of the original part of the business, saw a substantial reduction in its earnings due to oversupply and low margins in the European gas market.

In parallel, a number of major investments are still under construction and are therefore not operational yet. Major construction projects in the energy industry typically take several years to develop and construct. The money is expended in the investment phase whereas earnings do not materialise until the plants are in operation. In the years ahead, a positive effect will therefore filter through from the fact that a number of investments will become operational and start generating earnings.

DONG Energy is fully aware that it needs to strengthen its financial position. The company therefore announced an action plan in connection with the presentation of its interim financial report for the first nine months of 2012. According to the plan, the company's costs must be cut by DKK 1 billion, non-core activities to a value of DKK 10 billion must be divested, a sharper prioritisation must be made of forward-looking investments, and the loss-making activities in the gas market must be restructured. In connection with the presentation of DONG Energy's new strategy on 27 February, the management of DONG Energy will provide a status of the on-going work with the recovery plan, and precise targets will be set for the value creation to be delivered by the company in future.

Financial position under pressure in 2012
Rigsrevisionen concludes that DONG Energy is under pressure in 2012 on a number of key financial parameters.

The developments in the European gas market were the main reason for DONG Energy's unsatisfactory interim financial statements for the first nine months of 2012. Like most other large energy companies, DONG Energy has invested in gas-fired power stations in Europe, gas storage facilities and gas contracts in the expectation that gas would become a key element in the transformation of energy supply in Europe. However, this did not happen, partly due to very low coal and CO_2 prices that mean that coal-fired power stations are more competitive today than gas-fired power stations, despite their significantly higher CO_2 emissions. DONG Energy therefore had to recognise major impairment losses on its gas-fired power stations in 2012.

Furthermore, lower demand for gas and far smaller seasonal variations than previously have reduced the need for, and hence the value of, gas storage capacity. We have therefore also made major provisions for future losses on gas storage contracts.

Many of our competitors faced the same challenges in 2012. Vattenfall has thus had to recognise a SEK 8.6 billion impairment loss on its gas-fired power stations in the Netherlands, and E.ON has charged impairment losses totalling EUR 1.2 billion primarily relating to its gas business.

Divestments

According to Rigsrevisionen, divestments have netted fewer funds in 2012 than expected, and some of the divestment plans lacked a proper decision-making basis.

Every time DONG Energy divests an asset or stakes in an asset we are obviously talking about a unique divestment that is subject to great uncertainty with respect to the price and timing of the completion of the divestment. Our divestment plans consequently reflect DONG Energy's expectations at a given point in time with respect to the selling price that can be achieved and the timing of the completion of the divestment.

It is correct that DONG Energy made fewer divestments in 2012 than anticipated at the start of the year, and that the positive effect of these divestments therefore did not filter through in 2012.

Investments and risk management

Rigsrevisionen has reviewed eight selected investment projects. The eight projects represent more than half of DONG Energy's major investments that became operational in 2010 and 2011. Rigsrevisionen points out that the risk management on some of the projects was not satisfactory and that there were budget overspends on more than half of the investments.

It goes without saying that DONG Energy's investments must create value for the company's owners. We therefore focus tightly on earnings on the investments we make, and on risk management and avoiding budget overspends.

It is correct that there have been some instances of budget overspends. This reflects the fact that planning and managing large investment projects with great precision is a major challenge.

On the projects reviewed by Rigsrevisionen on which there have been budget overspends, the overspends range from 6% to 52%. The largest overspend, 52%, corresponds to DKK 168 million and relates to a budget overspend on our Inbicon R&D project in Kalundborg. Research and development projects are subject to greater uncertainty, and on this project this led to a higher level of unforeseen costs. It should be noted that this is a large overspend in percentage terms on an investment that is relatively smaller than other construction projects.

The second-largest overspend, 28%, related to the construction of the Gunfleet Sands offshore wind farm. On this project, we encountered a number of problems at subsuppliers. This overspend also represented the largest overspend in financial terms, DKK 960 million. This is of course not acceptable, and DONG Energy has adjusted various aspects of the management model for its major construction projects based on the experience gained on Gunfleet Sands.

In a business that involves major construction projects, tight control of project plans and budgets is all-important. However, even though we do everything in our power to avoid them, it is impossible to entirely avoid programme overruns and budget overspends on large projects on which we are highly dependent on specific weather conditions. In that context, it is worth noting that the average budget overspend on the investments reviewed by Rigsrevisionen is 7.7%. However, an international analysis of major infrastructure projects conducted by Professor Bent Flyvberg of Oxford University shows that budget overruns of that magnitude are at the low end of the spectrum compared with other projects.

Lastly, it is worth noting that Rigsrevisionen found that six out of eight projects have retained their value after becoming operational. This appears from Table 11 under ‘DONG Energy’s planning and implementation of projects’. A single project - a gas-fired power station - comes out negative, and one is described as not being relevant in this context, as an investment decision to develop the plant was never made.

Pay and bonus conditions

As part of its examination, Rigsrevisionen reviewed pay conditions at DONG Energy. According to Rigsrevisionen’s report, the pay level for most of DONG Energy’s employees is either in line with or below the market level. This applies to top management, the group of managers (top 300), a large group of middle managers, and specialists.

Rigsrevisionen concludes that the pay levels for some employee groups in craft-related areas and administrative and service areas are higher than the market level. According to Rigsrevisionen, there are indications that this also applies to a group of middle managers in the tier below the top 300 managers.

In this connection, attention should be paid to the following:

The pay level for employee groups in craft-related and administrative and service areas is historically rooted going back to the merged companies. There are mainly two reasons why efforts to bring the pay levels of these employee groups down to the market level have not yet succeeded:

1) In 2008, immediately before the financial crisis unfolded, DONG Energy, like the State, concluded a two-year agreement on the rate of pay increases. Accordingly, DONG Energy's pay increases in 2009 were higher than those of the other companies, which entered into one-year agreements. A management decision on zero pay adjustment in 2010 to halt the rate of pay increases failed to bring the pay level down to the market level.

2) Due to the financial crisis, the rate of pay increases across the labour market has been so low in subsequent years that it has not been possible to come down to the market level without making significant reductions in employee pay, and this is something management has wanted to avoid. Furthermore, DONG Energy is committed to respecting the collective agreement parties' agreements. Accordingly, the pay of employees who come under these agreements will rise even though DONG Energy announced zero adjustment in 2010.

Rigsrevisionen is urging DONG Energy to expand its use of systematic benchmarking to enable a greater extent of benchmarking against market levels.

DONG Energy has been working actively with systematic use of pay benchmarking since the merger. Unfortunately, relevant pay benchmarks are not always available for our type of business when it comes to benchmarking against pay levels in Denmark.

For some job profiles, e.g. in the oil and gas business, it is more relevant to benchmark against the pay level in the industry and geographical area in Northwestern Europe in which we operate. There are thus truer and fairer pay benchmarks in, for example, the UK market, where many more companies operate.

Rigsrevisionen concludes that there are indications that the pay level of some of the middle managers in DONG Energy is slightly higher than the market average. Rigsrevisionen also concludes that the pay level of another group of middle managers is below the market level.

Direct benchmarking of the pay level of middle managers at DONG Energy against a market average is difficult. Benchmarking should be against middle managers in companies of a similar size and complexity.

Rigsrevisionen's examination of the rate of pay increases shows that the pay of the group of managers increased by more than the rest of the labour market, but also that the rate of pay increases of the group of managers (top 300) was below the market level for comparable companies.

The group of managers at DONG Energy came from a low pay level, and we have remedied this in recent years. As Rigsrevisionen itself has concluded, the pay level for our group of managers (top 300) is lower than the market level. It is therefore completely natural for the rate of pay increases of that group to rise by more than the market in general.

5-11% of managers received bonus and remuneration in the period 2009-2011 jointly exceeding 25-30% of their basic pay.

The payment of bonus and remuneration is part of the overall pay package. Rigsrevisionen's overall conclusion is that DONG Energy's overall remuneration package for vice presidents and managers is below the pay benchmark for comparable companies.

DONG Energy has clear guidelines for the payment of bonus and non-recurring remuneration, partly with respect to the percentage of the pay that may be earned in the form of bonus in addition to the basic salary, and partly with respect to the payment of non-recurring remuneration.
DONG Energy applies the so-called 'grandfather principle'. This means that an employee's immediate superior cannot approve a payment and that the payment must be approved by the superior's superior. Bonus and exceptional remuneration for the Group Management require approval by the Board of Directors. This ensures that bonus and remuneration are not paid on an inadequate basis.

It is important to distinguish between the bonus scheme and exceptional, non-recurring remuneration. Bonus is a regular element of the pay model for managers and other key employees and is linked to the attainment of agreed performance conditions beyond what can expected of the particular job. In exceptional cases, managers and employees may be required to make an exceptional work contribution and/or create exceptional results beyond the performance conditions agreed in a bonus scheme. In such cases, their overall annual bonus payment may exceed the cap for the normal bonus scheme.

Expenses for management and administration

Rigsrevisionen considers it unsatisfactory that DONG Energy has been unable to determine expenses for management and administration accurately.

The reason DONG Energy has been unable to determine these expenses accurately as requested by Rigsrevisionen is that we have decided to switch from an income statement classified by function to an income statement classified by type of expenditure, like other large energy companies, to allow comparison of DONG Energy's financial statements with those of other European energy companies.

We continue to focus on the resources used in administrative areas, and we benchmark our expenses in specific areas against other companies on an ongoing basis rather than just viewing management and administration as an aggregate sum.

In the period from 2007 up to and including the third quarter of 2011, DONG Energy used an income statement classified by function in its financial reporting. As will be seen from Figure 9 under 'Administrative expenses' in Rigsrevisionen's report, the company's expenses for management and administration were relatively stable during this period, peaking in 2007. This should be viewed in the context of a 37% increase in revenue during that same period.

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