RIGSREVISIONEN

Extract from the report to the Public Accounts Committee on DONG Energy A/S

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revision

I. Introduction and conclusion

1. This report is about DONG Energy A/S (DONG Energy). The report was prepared at the request of the Danish Public Accounts Committee, which on 18 January 2012 asked Rigsrevisionen to examine various issues relating to DONG Energy's investments and wages and salaries and its financial contributions to the Danish State. The Public Accounts Committee also requested that Rigsrevisionen examine how the Danish Ministry of Finance is discharging its role as owner.

DONG Energy operates within the energy sector and was established through the merger of a number of energy companies in 2006. With revenue of DKK 56.8 billion and just over 6,000 employees in 2011, DONG Energy is Denmark's largest state-owned public limited company. The Danish State owns 80 per cent of DONG Energy's share capital, and the ownership role is being discharged by the Ministry of Finance.

DONG Energy has a long-term objective to provide clean and reliable energy. In recent years, DONG Energy has therefore implemented an extensive investment programme in excess of DKK 80 billion that is to contribute to a transformation of the business. Activities in construction and operation of offshore wind farms and oil and natural gas exploration and production are thus being given higher priority, while the company's activities in, for example, operation of conventional power stations are given lower priority.

2. The objective of the examination was to assess whether DONG Energy is delivering positive financial performance and whether, as a state-owned public limited company, sound financial considerations are being taken into account in its operation. Rigsrevisionen has examined these issues by answering the following questions:

- Is DONG Energy a robust and profitable business?
- Does DONG Energy plan its investments and manage the associated risks in a satisfactory manner?
- Are wages and salaries and employee benefits in DONG Energy in line with comparable companies?
- Is the Ministry of Finance safeguarding the State's interests in DONG Energy by taking an active ownership role?

The examination primarily covers the period following the merger in autumn 2006, ie the period from 2007 to the third quarter of 2012. However, as far as the issue of DONG Energy's wages and salaries is concerned, special emphasis is attached to the period 2009-2011.

MAIN CONCLUSION

Since the merger in 2006, DONG Energy has realigned its business model and made substantial investments, especially in offshore wind farms and oil and natural gas exploration and production. The purpose of the realignment was to generate growth and secure the company's future income base. Some investments are in operation while others are under construction and due to become operational in the coming years.

DONG Energy's equity ratio in the period 2007-2011 was satisfactory. Its earnings and profitability fluctuated during this period, in line with other energy companies. Apart from 2008 and 2010, the company's earnings have not been sufficient to secure a positive direct return covering the cost of capital. In 2012, the high investment level, coupled with declining earnings, puts the company, compared with other energy companies, under pressure on a number of key financial parameters. It is therefore crucial that the company's large investments – particularly in the wind area – generate the expected return in the coming years.

DONG Energy expects that its long-term investments will result in a marked improvement of its financial position in the years ahead.

Rigsrevisionen has reviewed a number of DONG Energy's major investments. The review has shown that several investments have already generated sound earnings or are expected to do so. However, DONG Energy has had to downgrade its future earnings expectations for some investments. In a few cases, the implication of this is that the investments in question are not expected to be profitable. As most of the investments have either only just become operational or are not due to become operational until 2-3 years from now, it is Rigsrevisionen's opinion that an assessment at this point of the extent to which DONG Energy's change of strategy will have the desired effect would be premature. Rigsrevisionen would like to point out that there are risks attached to the strategy, including the marked cyclical nature of the energy market that may have an adverse impact on the company's performance.

As a state-owned public limited company, DONG Energy is at liberty to offer its managers and employees competitive wages and salaries. However, the company should not be a pay level leader relative to comparable companies. DONG Energy's executives, senior and vice presidents and managers as well as a substantial group of employees including specialists, earn a salary that is below the level in comparable private companies.

However, DONG Energy's wages and salaries are more favourable, in other respects, than those offered by comparable companies. This applies especially to the company's administrative and customer service employees and its skilled and unskilled employees. One reason for this is that, in connection with the merger, the company took over employees with high pay levels from some of the companies that merged with DONG in 2006. The aim was that the pay levels of these groups were to be aligned with the rest of the labour market by way of relatively low pay increases. However, Rigsrevisionen has established that, six years after the merger, this process has yet to be completed.

Throughout the period in question, the Ministry of Finance has taken a position on DONG Energy's overall financial performance and election of a competent Board of Directors and has attended the company's general meetings. The Ministry of Finance has discharged its role as owner based on a principle that the company must, as far as possible, be run on commercial terms, with investments being made exclusively on market terms. However, the State expects DONG Energy to be an active player in the Danish market.

The Ministry of Finance took a very active role in connection with the merger in 2006 that concluded with six companies merging to become DONG Energy. The Ministry also took a very active role in connection with the preparation of the IPO.

After the IPO was called off in January 2008, the Ministry of Finance, in its capacity as owner, adopted a less active role in the period up to the end of 2010. Rigsrevisionen considers that, during the latter part of this period, the Ministry did not exercise the active ownership role expected of it as the Danish State's representative, considering the company's extensive investments and the risks the company was consequently taking on behalf of its owner.

In 2011 and 2012, the Ministry of Finance again took a more active role, intensifying its dialogue with DONG Energy.

The main conclusion is based on the following sub-conclusions:

Is DONG Energy a robust and profitable company?

Rigsrevisionen's examination has established that DONG Energy's equity ratio in the period 2007-2011 was satisfactory. The company's earnings and profitability fluctuated during the period in question. Apart from 2008 and 2010, the company's earnings have not been sufficient to secure a positive direct return covering the cost of capital. However, it must be expected that the return on capital employed will be relatively low during a period of high investment, but will rise over time.

In 2012, the company's earnings and equity ratio deteriorated, and the credit rating agency Standard & Poor's – one of the three rating agencies that follow DONG Energy – has downgraded its rating of the company. The rating is, however, still in accordance with DONG Energy's minimum rating target. DONG Energy's earnings from energy trading in the European markets are plummeting. In 2012, the cost of capital employed exceeded earnings from these investments in all the company's business units. Compared with eight other energy companies, DONG Energy's financial performance in 2012 was particularly poor. DONG Energy has stated that the company was under particular pressure in 2012, partly due to the market situation and loss making gas contracts in Germany, and partly due to major investments that have yet to become operational and have therefore not generated any earnings. DONG Energy has stated that the company expects its extensive investments to generate a positive return in the coming years.

Does DONG Energy plan its investments and manage the associated risks in a satisfactory manner?

Rigsrevisionen has reviewed DONG Energy's planning and risk management in relation to eight major investment projects and the Group's overall investment level.

Eight selected investments

Rigsrevisionen is of the opinion that most of the eight investment projects were satisfactorily planned. However, DONG Energy's risk management in relation to some of the projects has not been entirely satisfactory.

The investment projects have all been approved by the Board of Directors and initiated as part of the implementation of DONG Energy's strategy in the period up to 2015. The projects represent more than half of DONG Energy's major investments that became operational in 2010 and 2011.

Rigsrevisionen's examination has established that most of the investment projects reviewed are based on a satisfactory decision-making basis and have been implemented according to plan. However, the examination also found examples of shortcomings in the decision making basis and management of investments.

One project and two of the divestment agreements were thus decided on the basis of recommendations that did not adequately describe the risks associated with the investments and divestments. At the same time, there were budget overspends on more than half the projects reviewed. On two projects, there was an underspend of 4% and 11% respectively. The budget overspends varied between 6% and 52%. The 52% overspend related to a small research project with a budget of DKK 325 million. The largest overspend in numerical terms was approx. 960 million.

The investment projects must break even over a period of 20-30 years. It is therefore too early to determine the final return on the projects. According to DONG Energy's preliminary calculations, the oil exploration and wind energy projects reviewed are expected to generate a sound return for DONG Energy, whereas other projects are expected to generate lower earnings than expected, or outright losses, according to DONG Energy.

DONG Energy's overall investment level

Rigsrevisionen is of the opinion that DONG Energy's risk management in relation to the Group's overall investment level has not been entirely satisfactory, as it did not incorporate adequate risk margins to counter the challenges that arose in 2012.

In the period 2007-2012, DONG Energy's Board of Directors implemented follow-up to ensure that the investment level did not exceed DONG Energy's financial latitude; particularly against the background of DONG Energy's financial targets which set clear limits for the extent to which debt may exceed earnings.

On several occasions, the Board of Directors has expressed concern about the Group's investment level, especially in the wind area. The Board of Directors has therefore taken several active steps to ensure an investment level that is in line with the limits set by the company. However, in parallel, in the period until 2011, the Board has attached importance to maintaining the investment level set out in the Group's strategy. In 2011 and 2012, the Board of Directors deferred investment decisions due to the financial situation and rejected two investment proposals outside DONG Energy's strategic focus area.

Rigsrevisionen's examination shows that, because of the way in which DONG Energy's investments have been managed in the period until 2011, its debt – in relation to earnings – has been below or in line with the maximum limit adopted by the company. In 2012, the investment level exceeded the maximum considered a safe investment level – and consequently also the limit set by DONG Energy itself – by a significant margin.

The problems in 2012 reflected provisions for future losses on gas contracts and lower or delayed earnings from some of the Group's large investments. However, DONG Energy's financial position in 2012 was also affected by the fact that several of its divestments have been delayed or have brought in less than anticipated. In 2011 and 2012, DONG Energy included in the budget that part of the financing of its investments would come from divested activities and ownership interests in the projects. The divestments were expected to net a large billion-kroner sum. However, some of the divestment plans were not properly substantiated and a significant portion of the expected financing from these divestments has been delayed or lower than budgeted for.

Are wages and salaries and employee benefits in DONG Energy in line with comparable companies?

At the time of the merger in 2006, the Board of Directors and management of DONG Energy initiated a process that was to ensure harmonisation of wages and salaries and terms of employment in the company. According to DONG Energy, some employee groups from the former companies had relatively high wages and salaries. It was therefore the aim to align the wage and salary levels of these groups to the rest of the labour market by reducing the rate of wage and salary increases for these groups.

For use in its payroll management DONG Energy has prepared guidelines for pay, terms of employment, employee benefits, etc. One of the reasons for this is to help ensure that the company is able to offer competitive pay without becoming a pay level leader. DONG Energy carries out systematic pay benchmarking for selected groups of managers and employees, equivalent to approx. 1/5 of the company's employees. DONG Energy's systematic benchmarking comprises the group of managers and groups of employees in Exploration & Production and Energy Markets whose pay levels are driven, to some extent, by an international labour market. The company also carries out benchmarking on an ad hoc basis. Rigsrevisionen finds that DONG Energy should expand its use of systematic benchmarking to enable monitoring of pay levels for significant groups of managers and employees, thus ensuring that the company is not a pay level leader.

Rigsrevisionen has reviewed DONG Energy's benchmarking of pay levels for the group of managers in Exploration & Production and Energy Markets. Furthermore, Rigsrevisionen has been presented with the findings of analyses relating to employees in Wind Power, Group Procurement and Risk & Treasury Management. These analyses showed that the pay levels of both the 292 managers in the group of managers and the approx. 840 middle managers and employees whose pay should be benchmarked against an international labour market were lower than those offered by comparable companies.

Rigsrevisionen's own analyses of DONG Energy's pay level showed that, for example, administrative and customer service employees and skilled and unskilled employees in DONG Energy, who account for approx. 1/3 of the company's employees, had a higher level of pay in 2011 than that offered by comparable companies in the Danish labour market. There are also indications that most of the middle managers whose pay level should be benchmarked against the Danish labour market had a pay level slightly above that of the rest of the labour market.

With respect to the remuneration of the Board of Directors, Rigsrevisionen has found that the board members' remuneration is below the level in companies in the C20 index.

Rigsrevisionen's analysis of the trend in wages and salaries in DONG Energy shows that, in the period 2008-2011, the pay level for the group of managers rose by more than the rest of the labour market. This should be viewed in the context of this group's pay level being below the level in comparable companies. The rate of pay increases for the group of skilled and unskilled employees as well as for salaried employees also rose by more than that of the rest of the labour market during the period in question, partly due to a two-year collective agreement in 2008. In 2010, DONG Energy reduced the rate of pay increases for these groups, while the increase in 2011 was slightly higher than for the rest of the labour market. For historical reasons, skilled and unskilled employees as well as salaried employees have higher pay levels than the rest of the labour market. Rigsrevisionen has found that DONG Energy has not succeeded in aligning its pay level to the rest of the labour market by means of lower pay rises than the market, partly due to a lower rate of pay increases in the wake of the financial crisis. The rate of pay increases for the growing group of managers and academics, which represented approx. 60% of DONG Energy's employees in 2011, was below that of the rest of the labour market.

DONG Energy has capped bonus payments to managers and employees at 25-30% of their basic salaries. However, on top of this, they have the opportunity to earn one-off remuneration of up to one month's salary. This limit may be exceeded, but, for the Group Executive Management and the Executive Board, this is subject to approval by the Board of Directors, and, for the rest of the employees, it is subject to approval applying the 'grandfather principle', i.e. approval by the immediate superior's superior. Rigsrevisionen's examination has established that 5-11% of the managers received bonus and remuneration in the period 2009-2011 jointly exceeding 25-30% of their basic salaries.

Rigsrevisionen considers it unsatisfactory that DONG Energy has been unable to determine costs for management and administration accurately, and that, as part of a change to its income statement, the company is unable to determine these costs for 2011 and 2012. DONG Energy has informed Rigsrevisionen that, in connection with the change, the company monitors costs for management and administration via benchmarking in selected areas against comparable companies in the sector.

Does the Ministry of Finance safeguard the interests of the Danish State in DONG Energy by taking an active ownership role?

In the period 2007-2012, the Ministry of Finance took a position on DONG Energy's overall financial performance, the election of a competent Board of Directors and various other aspects of relevance to the company, including its dividend policy.

In addition, in the period until January 2008, when the planned IPO was suspended, the Ministry of Finance took an active position on the company's strategic development, and, again from 2011, it took an active position on the company's development. However, in the period after the IPO was suspended, the dialogue between the Ministry of Finance and DONG Energy on the latter's strategic development was limited. According to the Ministry, this was because DONG Energy's decisions largely reflected the strategy agreed in connection with the preparation of the IPO.

In the period from 2008 to the end of 2010, the Ministry of Finance thus adopted a less active approach to its ownership role. During this period, DONG Energy implemented an extensive investment programme with far-reaching consequences for the company's financial position. The strategy and investment programme involved increased risks for the State.

Although the company's decisions were largely a continuation of the strategy agreed in connection with the preparation of the IPO, Rigsrevisionen finds that the Ministry of Finance should have stepped up its dialogue with DONG Energy on the company's development at an earlier stage – and not later than during 2010, when the prospect of an IPO no longer existed – as the suspension of the IPO meant that there was a need to define a new ownership agenda in relation to the company. To this should be added the fact that DONG Energy's investment programme has had far-reaching consequences for the company's financial position, and that the company was experiencing considerable growth during that period.