# Changing the financial presentation of the Income Statement

**16 May 2011**

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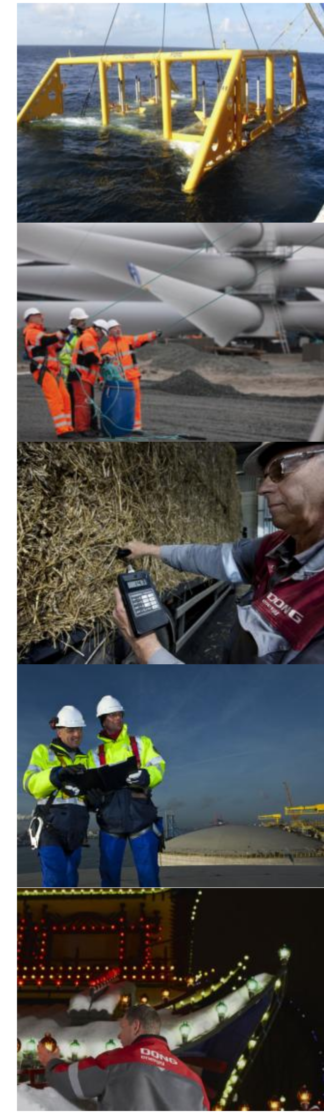
# Disclaimer

Certain statements in this presentation are based on the beliefs of our management as well as assumptions made by and information currently available to the management. Forward-looking statements (other than statements of historical fact) regarding our future results of operations, financial condition, cash flows, business strategy, plans and future objectives can generally be identified by terminology such as “targets”, “believes”, “expects”, “aims”, “intends”, “plans”, “seeks”, “will”, “may”, ”anticipates”, “continues ”or similar expressions.

A number of different factors may cause the actual performance to deviate significantly from the forward-looking statements in this presentation including but not limited to general economic developments, changes in temperature and precipitation, changes in market prices (e.g. oil, gas, power, coal, $CO_2$, currency), changes in the competitive environment, developments in the financial markets and changes in legislation or case law.

We urge you to read our annual report available on our website at www.dongenergy.com for a discussion of some of the factors that could affect our future performance and the industry in which we operate.

Should one or more of these risks or uncertainties materialise or should any underlying assumptions prove to be incorrect, our actual financial condition or results of operations could materially differ from that described herein as anticipated, believed, estimated or expected.



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# Summary

- DONG Energy actively hedges market price risks up to 5 years ahead with the objective of
  - Stabilising earnings and cash flow
  - Locking in value of production and/or transactions
  - Reducing risk towards adverse market price movements
- Ambition to match hedging activities with underlying risk exposure in P/L reporting
  - Applying hedge accounting (IAS39) to achieve a symmetrical P/L treatment of hedges and the underlying hedged exposures – specific requirements have to be fulfilled
  - Using "own use exemption" for certain physical deliveries – ensuring that the P/L effect matches the delivery period
- Increasingly difficult to match the hedge and the hedged item due to strict requirements
  - The timing of the accounting impact does not necessarily correspond to the economic impact of the hedges – i.e. asymmetry between the real economic impact and the accounting impact
  - Reduced transparency in the accounts
  - IAS 39 criteria impose restrictions on the optimal hedging decisions

**Introduce Business Performance result to maintain and increase transparency**

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# Applying hedge accounting has become increasingly difficult

- For DONG Energy, IAS 39 has in general achieved the purpose of matching the hedge and the hedged item

- Though it has become increasingly difficult to achieve this purpose
  - Very strict criteria have to be fulfilled
    - Low liquidity or no efficient derivatives market necessitates that hedging is conducted in other markets, products or time horizons with an expected high price correlation (proxy hedging)
    - Proxy hedges do not necessarily qualify for IAS 39 despite to a large extent achieving the desired economic effect
  - A significant increase in hedged volumes due to increased activities and price volatility
  - An increased focus on utilising DONG Energy's integrated position
    - Managing the risk on a portfolio level instead of individual transactions – an increased utilisation of internal hedges and covariances

For an integrated energy company like DONG Energy, utilising energy markets actively to achieve the most effective economic hedges of the risk exposure, hedge accounting is increasingly difficult to achieve

IAS 39 hedge accounting criteria restrict optimal hedging decisions

**DONG Energy ceases to apply hedge accounting***

- Ensuring same treatment of all economic hedges
- Ensuring that optimal hedging decisions continue to be primary driver of decision making

* For new derivatives entered into from 1 January 2011

# Own use exemption

- The governing principle in IAS 39 (accounting for derivatives) apply to both physical and financial derivatives*
- However, derivatives with physical delivery (as opposed to cash settlement) are exempt from IAS 39 if they meet certain criteria – also known as the "own use criteria"
- Whether or not the own use exemption is applicable is governed in IAS 39 – it is not up to the entity to decide whether or not to use the own use exemption

- With the development in European energy markets, the opportunities for actively managing (both selling and buying) the physical portfolio of DONG Energy has increased
- As a consequence, DONG Energy has opened up for utilising the physical markets to actively manage the price risks and the physical optimisation of the portfolio

- As a result, physical transactions at fixed prices no longer meet the criteria for the own use exemption of IAS 39 => have to be MtM accounted via the P/L (as opposed to being accounted for only upon realisation) – e.g. gas portfolio
- The physical transactions will therefore obtain the same accounting treatments as financial products offered to customers in combination with the physical contracts

**Reducing risk by locking in prices causes increased accounting P/L volatility**

* According to the definition of a derivative in IAS 39

# Introduction of a three column Income Statement

**Purpose: Increase transparency and better reflect the underlying actual performance**

**Cease to apply hedge accounting**

**Criteria for the own use exemption in IFRS no longer met**

MtM movements from hedges and some physical deliveries will be accounted for directly in P/L

This increases volatility in the IFRS result

Only affects the timing of the accounting impact and has no real economic or cash flow impact

A three column Income Statement is introduced splitting the IFRS result into two buckets:

**Business Performance**
The result related to the actual reporting period – i.e. the value creation for the period

**Adjustments**
MtM movements not attributable to the period's result

**Implemented as of 1 January 2011**

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# Business Performance – the methodology

- The Business Performance result shows the result related to the current reporting period excluding effects from MtM movements not attributable to the period's result

$$\text{Realised value}_{\text{in period}} + \text{Market value}_{\text{end of period}} - \text{Market value}_{\text{start of period}} = \text{IFRS}$$

Value concerning the period's result

Closing market value concerning future periods

Opening market value concerning the period's result and future periods

<table>
<tr><th></th><th>Business Performance</th><th></th><th>Adjustments</th><th></th><th>IFRS</th></tr>
<tr><td>Revenue</td><td rowspan="5">Realised result for the period</td><td rowspan="5">+</td><td rowspan="5">Mark to Market (MtM) adjustments not attributable to the period's result</td><td rowspan="5">=</td><td rowspan="5">Result incl. MtM adjustments not attributable to the period's result</td></tr>
<tr><td>Production costs</td></tr>
<tr><td>Gross Profit</td></tr>
<tr><td>...</td></tr>
<tr><td>Profit for the year</td></tr>
</table>

# Business Performance characteristics

- Business Performance is the underlying result related to the current reporting period
- No adjustments for extraordinary items incl. one offs – adjustments are only made for MtM movements related to other periods. Hence, one offs are included in Business Performance
- Business Performance only changes the timing of the accounting effect to reflect the actual decisions and management of DONG Energy
  - The aggregate Adjustments will over time accumulate to zero
  - Business Performance plus Adjustments will for each period equal the IFRS result
- Business Performance closely corresponds to and reflects the financial management and governance of DONG Energy
  - The internal management of DONG Energy is based on Business Performance as it better reflects decisions and performance of DONG Energy
- The new presentation of the Income Statement has <u>no</u> impact on the Cash Flow Statement or the capital structure ratio – the change is purely a changed accounting presentation
- The new presentation of the Income Statement is in full compliance with IFRS presentation rules
- As the new presentation follows IFRS presentation rules it is audited by external auditors in line with the rest of the financial report

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# Adjustments – what is adjusted for?

**MtM movements excluded from Business Performance – included in Adjustments**

- Derivative contracts which hedge underlying risk exposures. This ensures that the MtM effect of the hedges is not presented in the Business Performance column until the underlying hedged exposure is realised and has P/L effect – ensuring a symmetrical treatment
- Physical transactions, incl. financial products offered to customers in combination with the physical contracts, transacted as part of the active management of DONG Energy's physical portfolio – ensuring that reducing risk by fixing prices is accounted for as such in Business Performance

**Which MtM movements are included in Business Performance?**

- All trading activities not hedging underlying exposure
- All deviations from a perfect hedge: The part of the MtM movements which is not 100% hedging the underlying exposure (compared to the 80-125% rule of IAS 39) => Deviations from the perfect hedge – due to e.g. proxy hedging – are presented directly in Business Performance

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# Changes to the IFRS P/L

## Cease to apply IAS 39 hedge accounting

- The provisions in IAS 39 about hedge accounting will not be applied going forward for financial energy and FX derivatives – MtM movements will be accounted for directly in the P/L
- Though for hedging of IR risk and FX risk related to the balance sheet (investments), hedge accounting will still be applied

## Criteria for the "own use exemption" no longer met

- Physical transactions not exempt from IAS 39 will be MtM accounted in the P/L
- This includes the VPP auctions (Virtual Power Plant) which will also be MtM accounted in the P/L

## Main initial effects to the P/L

- **Physical gas contracts**
  - Used as hedges of DONG Energy's gas portfolio reducing market price exposure
  - Formerly only NBP gas contracts were MtM accounted
  - New contracts to be included are e.g. physical transactions with delivery at TTF
  - Market value, end 2010: DKK -0.9bn
- **VPP auctions**
  - Physical call option on power production sold according to agreement with Danish competition authorities
  - Previously considered as a commercial contract regarding the Danish power production – now considered a hedge of Danish power production
  - Market value, end 2010: DKK -0.9bn

- **Will not impact Business Performance**
- **No cash flow effect**

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# Conclusions

- Presenting the Income Statement in three columns explicitly illustrates the impact from hedging activities => increasing transparency
- The IFRS result, which is impacted by MtM movements of hedges concerning other periods, should be seen in conjunction with the Business Performance result
- Business Performance result provides a more relevant and true representation of the underlying actual results in DONG Energy
- The focus on Business Performance results allows DONG Energy to undertake the most efficient hedging decisions and realise the full value from being an integrated energy company

- The consequence of changing the treatment of hedging instruments is only a movement of financial accounting results across accounting periods with <u>no</u> cash flow impact

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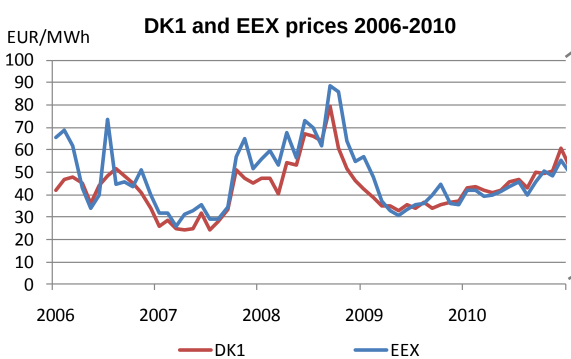
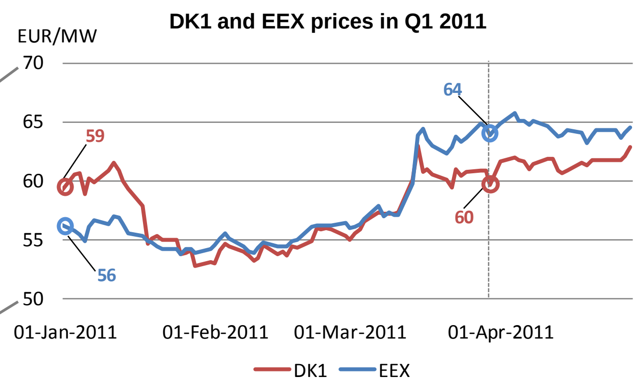
# Example 1: Challenges with proxy hedging on Nord Pool

- Power prices in Denmark cannot be perfectly hedged due to periodically low liquidity in Danish power price contracts on the Nord Pool power exchange
- Instead the German (EEX) or the Nord Pool system price contract is often used as a proxy hedge for Danish prices
- If the market value movement of the hedge (EEX) is not within 80%-125% of the market value movement of the hedged item (DK1), the hedge is not effective according to IAS 39 and does not qualify for hedge accounting. This is measured between two specific dates irrespective of whether the correlation has been high – economically efficient – during the period




*Note: Monthly average*




| Q1 2011 | EEX | DK1 |
|---|---|---|
| Start date | 56 | 59 |
| End date | 64 | 60 |
| Change in price | 8.0 | 1.4 |

Difference between change in EEX and DK1 is too large to qualify for hedge accounting

**Hedge accounting is dependent on the actual price development between two specific dates**

# Example 2: Challenges with hedge accounting of German oil products

- DONG Energy hedges price indexations in gas contracts
- If the price in a gas contract is linked to the development in oil prices, the actual price exposure is an oil exposure
- Some of the gas contracts are indexed to price quotations for which no forward market exists. DONG Energy therefore has to hedge using derivatives in other similar markets
- Historically a high correlation resulting in an economic hedge
- Since there is no forward price to compare with the hedge effectiveness test cannot be carried out

**The hedges do not qualify for hedge accounting**

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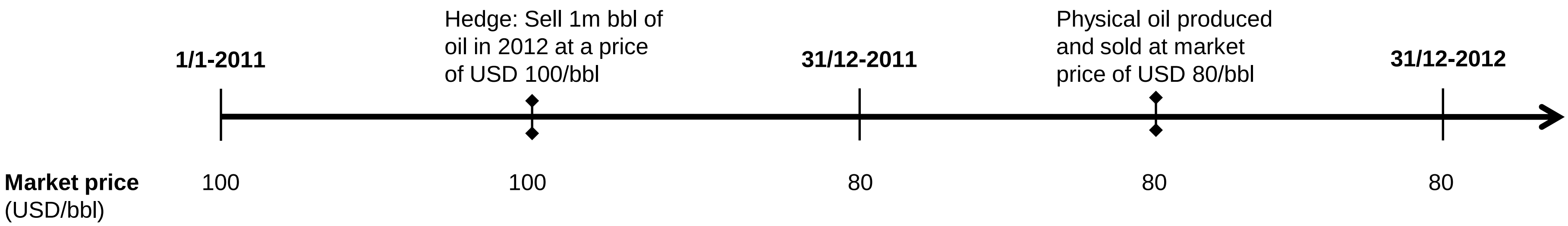
# Example 3: Hedging of crude oil production

## DONG Energy expects to produce and sell 1m bbl of oil in 2012




## Impact of the transaction in the three columns in the Income Statement (incl. underlying exposure)

| DKKm | Business Performance<br>(realised in the period) | Adjustments<br>(value of open position end of period *less* value open positions start of period) | IFRS |
|---|---|---|---|
| 2011 | Hedge: 0<br>Exposure: 0<br>**Total: 0** | Hedge: +20<br>Exposure: 0<br>**Total: +20** | Hedge: +20<br>Exposure: 0<br>**Total: +20** |
| 2012 | Hedge: +20<br>Exposure: +80<br>**Total: +100** | Hedge: -20<br>Exposure: 0<br>**Total: -20** | Hedge: 0<br>Exposure: +80<br>**Total: +80** |
| **Total** | **+100** | **0** | **+100** |

- **Business Performance shows the result of the transaction for the period where it actually takes place – and correctly reflects locking in value of future production**
- **Over time Business Performance equals IFRS**

# Example 4: Hedging of Danish power production

## DONG Energy expects to produce and sell 1MWh of Danish power (DK1) in 2012

| | 1/1-2011 | Proxy hedge with EEX: Sell 1MWh in 2012 at a price of EUR 60/MWh | 31/12-2011 | Physical power (DK1) produced and sold at market price of EUR 45/MWh | 31/12-2012 |
|---|---|---|---|---|---|
| **Market price:** | | | | | |
| DK1, EUR/MWh | 50 | 50 | 45 | 45 | 45 |
| EEX, EUR/MWh | 60 | 60 | 56 | 56 | 56 |
| **MtM:** | | | | | |
| Exposure (DK1) | | | -5 | | 0 |
| Hedge (EEX) | | | +4 | | 0 |
| *- Hedge (DK1)* | | | *+5* | | *0* |
| *- Basis risk (DK1 <> EEX)* | | | *-1* | | *0* |

## Impact of the transaction in the three columns in the Income Statement (incl. underlying exposure)

| EUR | **Business Performance** (realised in the period) | | **Adjustments** (value of open position end of period *less* value open positions start of period) | | **IFRS** |
|---|---|---|---|---|---|
| 2011 | Hedge: -1<br>Exposure: 0<br>**Total: -1** | | Hedge: +5<br>Exposure: 0<br>**Total: +5** | | Hedge: +4<br>Exposure: 0<br>**Total: +4** |
| | | + | | = | |
| 2012 | Hedge: +5<br>Exposure: +45<br>**Total: +50** | | Hedge: -5<br>Exposure: 0<br>**Total: -5** | | Hedge: 0<br>Exposure: +45<br>**Total: +45** |
| **Total** | **+49** | | **0** | | **+49** |

- **Business Performance reflects the perfect hedge**
- **Deviations from the perfect hedge (basis risk between DK1 and EEX) is instantly accounted for in Business Performance**

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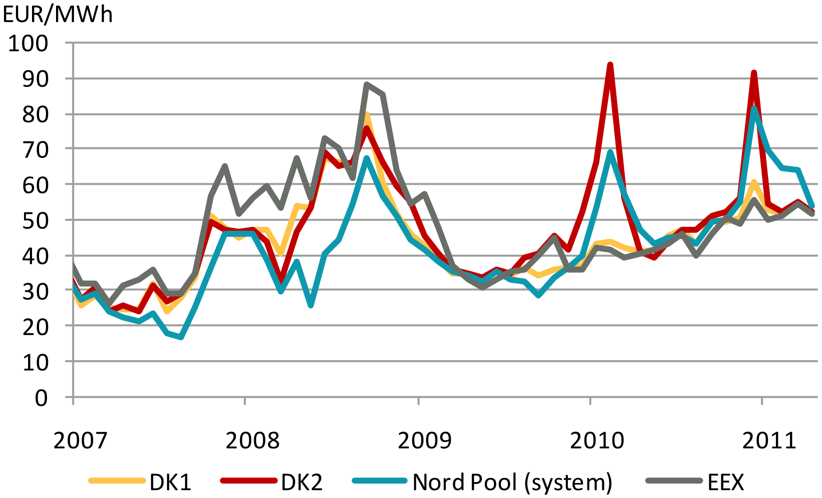
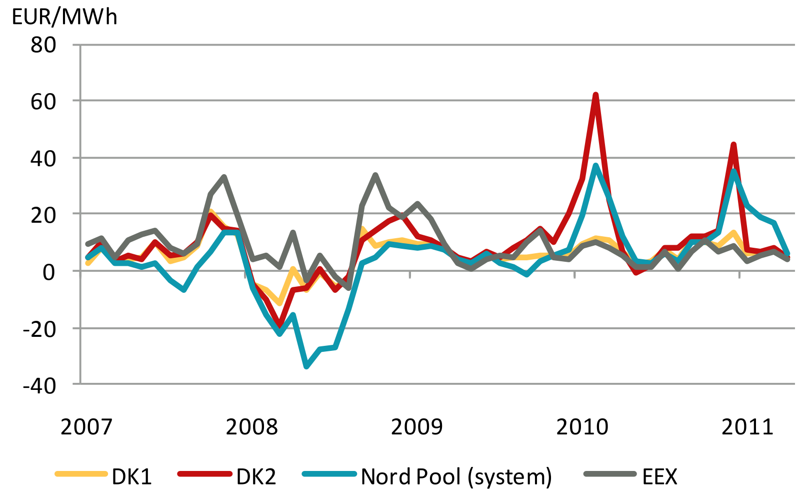
# Market price development

## Power prices (monthly average)



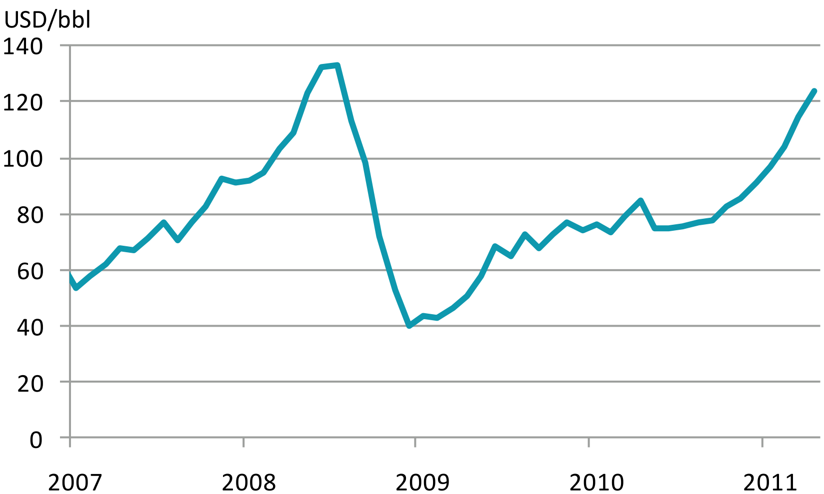

Source: Argus

## Green Dark Spread (monthly average)



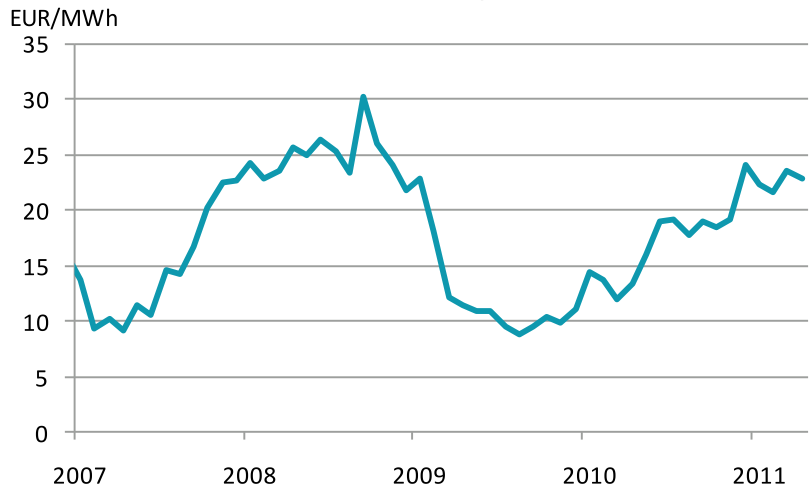

Source: Platts

## Oil prices (monthly average)




Source: Platts

## Gas prices (monthly average)




Source: Argus

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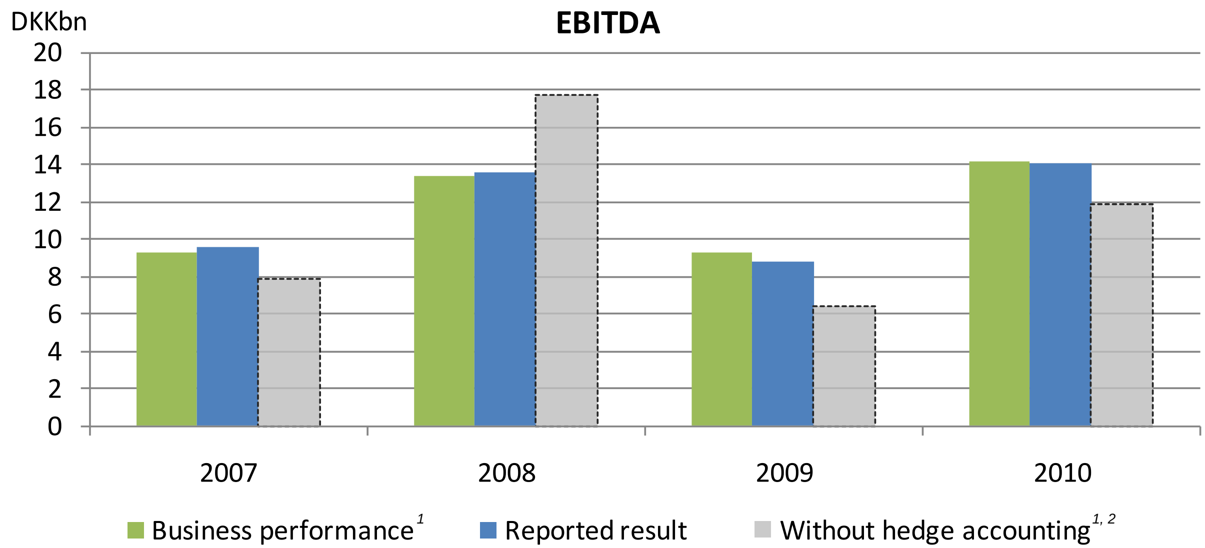
# Historical Business Performance




*Note (1): Unaudited numbers*

*Note (2): The numbers for "Without Hedge Accounting" represent DONG Energy's best estimate of the historical results without hedge accounting*

- DONG Energy's hedging activity has had a significant impact on the results – smoothing the effect of price changes
- In 2008 the falling energy prices resulted in gains on hedging contracts entered into during 2008 – though this positive MtM was related to commercial positions in the following years
- In 2009 the low level for energy prices resulted in gains on the realised hedging contracts related to positions in 2009
- Impact from MtM of hedging contracting is increasing due to rising volumes of hedging

# Historical Business Performance

- In general, a large part of the hedges has historically been hedge accounted
- Though there has been some ineffectiveness
  - The main difference between Business Performance and the Reported result is related to ineffectiveness of hedges for oil, gas, power, coal and $CO_2$
- The accounting of time value and option premia also explain some of the difference

| EBITDA DKKm | 2007 | 2008 | 2009 | 2010 |
|---|---|---|---|---|
| **Reported Result** | **9,606** | **13,622** | **8,840** | **14,089** |
| **Business Performance**[1] | **9,323** | **13,428** | **9,311** | **14,136** |
| **Difference** | **283** | **194** | **-471** | **-47** |
| *Oil* | *0* | *22* | *230* | *255* |
| *Gas* | *0* | *0* | *8* | *89* |
| *Power, coal & $CO_2$* | *368* | *275* | *-896* | *-324* |
| *Options* | *-85* | *-103* | *186* | *-67* |

*Note (1): Unaudited numbers*

NB: Detailed historical comparison numbers for Business Performance will be made available on www.dongenergy.com in the Investor section – Key Figures

# Concluding remarks

- The  consequence of changing the treatment of hedging instruments is only a movement of financial accounting results across accounting periods with no cash flow impact

- Presentation of the Business Performance results provides a more relevant and true representation of the underlying results in DONG Energy and enhances transparency

- The focus on Business Performance results allows DONG Energy to undertake the most efficient hedging decisions and realise the full value from being an integrated energy company

# Appendix – How does hedge accounting work

- The governing principle in IAS 39 is to account for fair value movements (MtM) of the derivative directly in the P/L

**Hedge accounting**

- An exception to the governing principle in IAS 39 is hedge accounting
- Allows for the accounting effects of the hedges (derivatives) to be matched to the same time period as the hedged item
- Derivatives considered as hedges at the inception of the contract will continue to be considered as hedges until the contract expires
- Hedge accounting is associated with a complex and strict set of rules with the purpose of ensuring that only effective hedges qualify for hedge accounting
- Hedge accounting is a choice: Entities can choose to either account for derivatives with MtM movements directly impacting the P/L or to apply hedge accounting

- DONG Energy has historically applied hedge accounting to increase transparency

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