Polskie Górnictwo Naftowe
i Gazownictwo SA

DIRECTORS' REPORT ON THE OPERATIONS OF THE PGNiG GROUP AND PGNiG S.A. IN H1 2016

TABLE OF CONTENTS

1. PGNiG GROUP

1.1. Description of business

The PGNiG Group operates in the energy sector in Poland and abroad. The parent of the PGNiG Group is Polskie Górnictwo Naftowe i Gazownictwo S.A.

Polskie Górnictwo Naftowe i Gazownictwo Spółka Akcyjna (PGNiG S.A.), with registered office in Warsaw, ul. Marcina Kasprzaka 25, was incorporated through transformation of the state-owned enterprise Polskie Górnictwo Naftowe i Gazownictwo into a state-owned stock company. On October 30th 1996, the Company was entered in the commercial register as Polskie Górnictwo Naftowe i Gazownictwo S.A. of Warsaw, under No. RHB 48382. On November 14th 2001, it was entered in the business register of the National Court Register under No. 0000059492.

On May 24th 2005, the Polish Securities and Exchange Commission admitted PGNiG shares to public trading. The Company floated its shares on the Warsaw Stock Exchange on September 23rd 2005. PGNiG shares have been listed on the Warsaw Stock Exchange since October 20th 2005. Currently, the share capital of PGNiG S.A. amounts to PLN 5.9bn and is divided into 5,900,000,000 shares with a par value of PLN 1 per share.

The PGNiG Group holds the leading position in most segments of the Polish gas sector, i.e. in oil and gas exploration and production, gas fuel storage, natural gas trading, and natural gas distribution. The Group's oil and gas upstream operations, carried out primarily in Poland and on the Norwegian Continental Shelf, provide the Group with competitive advantage on the liberalising gas market. The Group's trade and storage operations focus on selling natural gas imported from other countries or produced domestically, and on providing gas supplies at times of peak demand. The distribution business involves supply of gas to customers via the distribution network, as well as continuous expansion and upgrades of the gas network. In 2012, the PGNiG Group expanded its operations to include generation and sale of electricity and heat.

1.2. Structure of the Group

As at June 30th 2016, the Group comprised PGNiG S.A. (the Parent), and 31 production, trade and service companies, including:

- 19 direct subsidiaries of PGNiG S.A.
- 12 indirect subsidiaries of PGNiG S.A.

The list of the PGNiG Group companies as at June 30th 2016 is presented in the table below.

Companies of the PGNiG Group

	Name	Share capital (PLN)	Par value of shares held by PGNiG S.A. (PLN)	Ownership interest: PGNiG S.A.	Ownership interest: PGNiG Group
	Subsidiaries – first tier				
1	B.S. i P.G. Gazoprojekt S.A.	4,000,000	900,000	22.50%	75.00%[2)]
2	Exalo Drilling S.A.	981,500,000	981,500,000	100.00%	100.00%
3	GEOFIZYKA Kraków S.A.	64,400,000	64,400,000	100.00%	100.00%
4	GEOFIZYKA Toruń S.A.	66,000,000	66,000,000	100.00%	100.00%
5	Geovita S.A.	86,139,000	86,139,000	100.00%	100.00%
6	Operator Systemu Magazynowania Sp. z o.o.	15,290,000	15,290,000	100.00%	100.00%
7	PGNiG Obrót Detaliczny Sp. z o.o.	600,050,000	600,050,000	100.00%	100.00%
8	PGNiG Serwis Sp. z o.o.	9,995,000	9,995,000	100.00%	100.00%
9	PGNiG Technologie S.A.	182,127,240	182,127,240	100.00%	100.00%
10	PGNiG TERMIKA S.A.	1,240,324,950	1,240,324,950	100.00%	100.00%
11	Polska Spółka Gazownictwa Sp. z o.o.	10,454,206,550	10,454,206,550	100.00%	100.00%
12	PGNiG Finance AB (SEK) [1)]	500,000	500,000	100.00%	100.00%
13	PGNiG Supply & Trading GmbH (EUR)[1)]	10,000,000	10,000,000	100.00%	100.00%
14	PGNiG Upstream International AS (NOK)[1)]	1,092,000,000	1,092,000,000	100.00%	100.00%
15	Polish Oil and Gas Company-Libya B.V. (EUR)[1)]	20,000	20,000	100.00%	100.00%
16	GAS-TRADING S.A.	2,975,000	1,291,350	43.41%	79.58%[3)]
17	PGNiG SPV 5 Sp. z o.o.	250,000	250,000	100.00%	100.00%
18	PGNiG SPV 6 Sp. z o.o.	51,381,000	51,381,000	100.00%	100.00%
19	PGNiG SPV 7 Sp. z o.o.	250,000	250,000	100.00%	100.00%
	Subsidiaries – second tier				
20	Przedsiębiorstwo Energetyki Cieplnej S.A.	85,000,000	85,000,000	-	100.00%[4)]
21	Ośrodek Badawczo-Rozwojowy Górnictwa Surowców Chemicznych CHEMKOP Sp. z o.o.	3,000,000	2,565,350	-	85.51%[5)]
22	Gas Assets Management Sp. z o.o.	1,360,000	1,360,000	-	100.00%[6)]
23	Gas-Trading Podkarpacie Sp. z o.o.	6,670,627	5,257,524	-	78.82%[7)]
24	GAZ Sp. z o.o.	300,000	300,000	-	100.00%[8)]
25	NYSAGAZ Sp. z o.o.	9,881,000	9,881,000	-	100.00%[9)]
26	Powiśle Park Sp. z o.o.	81,131,000	81,131,000	-	100.00%[8)]
27	Zakład Gospodarki Mieszkaniowej Sp. z o.o.	1,806,500	1,806,500	-	100.00%[10)]
28	Oil Tech International F.Z.E. (USD)[1)]	20,000	20,000	-	100.00%[10)]
29	Poltava Services LLC (EUR)[1)]	20,000	20,000	-	100.00%[10)]
30	PST Europe Sales GmbH (EUR)[1)]	1,000,000	1,000,000		100.00%[11)]
	Subsidiaries – third tier				
31	XOOL GmbH (EUR)[1)]	500,000	500,000	-	100.00%[12)]

1) In foreign currencies.
2) Indirect interest held through PGNiG Technologie S.A.: 52.5%. PGNiG S.A. has the right to appoint the majority of the company's supervisory board members.
3) Indirect interest held through SPV 6 Sp. z o.o.: 36.17%.
4) Indirect interest held through PGNiG TERMIKA S.A.
5) Indirect interest held through Operator Systemu Magazynowania Sp. z o.o.
6) Indirect interest, with 99.98% held through PGNiG SPV 6 Sp. z o.o. and 0.02% held through PGNiG SPV 5 Sp. z o.o.
7) Indirect interest held through GAS-TRADING S.A.
8) Indirect interest held through Polska Spółka Gazownictwa Sp. z o.o.
9) Indirect interest held through PGNiG TERMIKA S.A.
10) Indirect interest held through Exalo Drilling S.A.
11) Indirect interest held through PGNiG Supply & Trading GmbH.
12) Indirect interest held through PGNiG Supply & Trading GmbH and PST Europe Sales GmbH.

Changes in the PGNiG Group in H1 2016:

- On January 4th 2016, a reduction of share capital of PGNiG Obrót Detaliczny Sp. z o.o. was registered with the National Court Register. On August 28th 2015, the Extraordinary General Meeting of PGNiG Obrót Detaliczny Sp. z o.o. passed a resolution to reduce the company's share capital by PLN 490.95m, to PLN 600,05m, by reducing the par value of 10,910,000 shares (from PLN 100 per share to PLN 55 per share).
- On January 14th 2016, a share capital increase at Gas Assets Management Sp. z o.o. was registered with the National Court Register; the share capital was increased by PLN 1.34m, to PLN 1.36m on October 28th 2015; 6,700 shares in the increased share capital were acquired by PGNiG SPV 6 Sp. z o.o. by way of conversion of debt (loan from PGNiG SPV 6 Sp. z o.o.) into the company's equity.
- On February 9th 2016, an amendment to GAZ Sp. z o.o.'s Articles of Association was registered with the National Court Register. On October 26th 2015, the General Meeting of GAZ Sp. z o.o. passed a resolution to amend the company's Articles of Association by increasing the par value of its shares to equalise their total par value with the share capital. As a result, the share capital of PLN 300 thousand is divided into 160 shares with a par value of PLN 1,875 per share.
- On March 31st 2016, the General Meeting of Poltava Services LLC passed a resolution to exclude Mr Hubert Leszek Praski-Ćwiok from the list of shareholders of Poltava Services LLC. Consequently, Exalo Drilling S.A. acquired the 1% interest held by Mr Praski-Ćwiok in the share capital of Poltava Services LLC, thus increasing Exalo Drilling S.A.'s share in the share capital to UAH 229.2 thousand (i.e. by UAH 2,292 or EUR 200). Exalo Drilling S.A. currently holds 100% of shares in the share capital of Poltava Services LLC. The transaction was registered with the state register in Ukraine on April 19th 2016.
- On April 19th 2016, the Extraordinary General Meeting of PGNiG TERMIKA S.A. passed a resolution to increase the company's share capital from PLN 670.32m to PLN 1,240.32m, i.e. by PLN 570m. The increase was effected by way of issue of 57,000,000 Series F registered ordinary (non-preference) shares with a par value of PLN 10 per share. All new shares were acquired by PGNiG S.A. for cash 9PLN 570,000,000). The increase was registered with the National Court Register on May 17th 2016.

  On April 28th 2016, under an agreement with Spółka Energetyczna Jastrzębie S.A., PGNIG TERMIKA S.A. acquired, for PLN 190.4m, 85,000,000 shares in the share capital of Przedsiębiorstwo Energetyki Cieplnej S.A. of Jastrzębie Zdrój. The acquired shares, with a par value of PLN 1 per share, represent 100% of the share capital of Przedsiębiorstwo Energetyki Cieplnej S.A.

Changes subsequent to the end of the reporting period

On July 4th 2016, PGNiG TERMIKA S.A. and Jastrzębska Spółka Węglowa S.A. executed a preliminary agreement for the purchase of shares in Spółka Energetyczna Jastrzębie S.A. (SEJ). Under the agreement, PGNiG TERMIKA S.A. made an advance payment for the SEJ shares. Once the conditions precedent are satisfied, the parties will execute a share purchase agreement whereby PGNiG TERMIKA S.A. will acquire 2,882,333 shares with a par value of PLN 100 per share and total par value of PLN 288.23m, representing 100% of SEJ's share capital. As at the date of this report, the conditions precedent were not met.

On July 29th 2016, the Extraordinary General Meeting of PGNiG Upstream International AS of Sandnes, Norway, passed a resolution to increase the company's share capital by NOK 8m, by way of issue of 8,000 new shares with a par value of NOK 1,000 per share and a subscription price of NOK 37,500 per share, i.e. a total subscription price of NOK 300m. The General Meeting also amended the company's articles of association to reflect the capital increase. The capital increase will take effect upon its registration. The new shares will be acquired by PGNiG S.A.

On August 1st 2016, the Extraordinary General Meeting of GEOFIZYKA Kraków S.A. passed a resolution to dissolve the company, thus commencing liquidation of the company.

As at June 30th 2016, the consolidated companies were PGNiG S.A. (the Parent) and 22 subsidiaries. The chart below presents the consolidated companies of the PGNiG Group as at June 30th 2016 (by segment).

Consolidated PGNiG Group companies

Parent		
Polskie Górnictwo Naftowe i Gazownictwo S.A.		
Segment	Subsidiaries	Ownership interest held by PGNiG S.A.
Exploration and Production	Exalo Drilling S.A.	100%
	Oil Tech International F.Z.E.	100%
	Poltava Services LLC	100%
	GEOFIZYKA Kraków S.A.	100%
	GEOFIZYKA Toruń S.A.	100%
	PGNiG Upstream International AS	100%
	Polish Oil and Gas Company - Libya B.V.	100%
Trade and Storage	PGNiG Obrót Detaliczny Sp. z o.o.	100%
	PGNiG Supply & Trading GmbH	100%
	PST Europe Sales GmbH	100%
	XOOL GmbH	100%
	Operator Systemu Magazynowania Sp. z o.o.	100%
	PGNiG Finance AB	100%
Distribution	Polska Spółka Gazownictwa Sp. z o.o.	100%
	Powiśle Park Sp. z o.o.	100%
	GAZ Sp. z o.o.	100%
Generation	PGNiG TERMIKA S.A.	100%
	Przedsiębiorstwo Energetyki Cieplnej S.A.	100%
Other Activities	Geovita S.A.	100%
	PGNiG Technologie S.A.	100%
	PGNiG Serwis Sp. z o.o.	100%
	B.S. i P.G. Gazoprojekt S.A. *	75%

* PGNiG S.A. has the right to appoint the majority of the company's Supervisory Board members.
PGNiG S.A.'s direct interest in the share capital of B.S. i P.G. Gazoprojekt S.A. is 22.50%.
Also, PGNiG S.A. holds a 52.50% indirect interest in the company through PGNiG Technologie S.A.

1.3. Workforce

The table below presents PGNiG S.A.'s and the PGNiG Group's workforce as at June 30th 2016, by segment. Employees of the PGNiG Head Office are included in the Trade and Storage segment.

Workforce by segment (no. of staff)

	PGNiG S.A.	PGNiG Group
Exploration and Production	3,847	8,141
Trade and Storage	934	3,500
Distribution	-	10,749
Generation	-	1,587
Other Activities	40	1,319
Total	**4,821**	**25,296**

As at June 30th 2016, PGNiG S.A. employed 4,821 persons, 53 fewer than as at December 31st 2015. The decrease was mainly caused by the transfer of field employees of accounting units to PGNiG Obrót Detaliczny Sp. z o.o., under Art. 23[1] of the Labour Code. On April 28th 2016, the PGNiG Management Board approved the rules of procedure for the Voluntary Redundancy Programme for PGNiG S.A. employees. The approved programme is one of the Company's initiatives implemented to improve productivity and optimise operations. As at the date of this report, the number of employees eligible to participate in the programme was estimated at 170. The majority of the participants will terminate their employment as of September 30th 2016.

In the first half of 2016, the PGNiG Group continued the employment restructuring process. As at June 30th 2016, the PGNiG Group employed 25,296 staff, 123 fewer than as at December 31st 2015. The decrease was one of the intended effects of the PGNiG Group's strategy for 2014−2022, designed to improve the organisation's cost effectiveness and productivity.

The segment most affected by the restructuring process has been the Exploration and Production, where the employment was reduced by 762 staff in the first half of 2016. The largest reduction of workforce was seen at GEOFIZYKA Kraków S.A. (357 persons), mainly due to the completion of certain projects in Pakistan and the continued employment restructuring process. GEOFIZYKA Toruń S.A. reduced its workforce by 206 persons. The workforce reduction was to align the number employees with the company's needs and the current market situation. The restructuring process also continued at Exalo Drilling S.A., where the number of employees was reduced by 200.

In the Generation Segment, the workforce increased by 516 staff, following the addition of Przedsiębiorstwo Energetyki Cieplnej S.A. (PEC Jastrzębie S.A.) of Jastrzębie Zdrój to the PGNiG Group. PGNiG TERMIKA S.A. purchased 100% of shares in PEC Jastrzębie S.A. in April 2016.

Changes in the employment numbers in the other segments of the PGNiG Group were insignificant and were caused by natural workforce fluctuations.

The tables below present the employment statistics for PGNiG S.A. and the PGNiG Group as at June 30th 2016 by age, education and length of service.

Employment at PGNiG S.A. and the PGNiG Group as at June 30th 2016 by age (no. of staff)

	PGNiG S.A.	PGNiG Group
Up to 24 years	34	294
From 25 to 34 years	861	3,913
From 35 to 44 years	1,457	6,966
From 45 to 55 years	1,374	8,909
Over 55 years	1,095	5,214
Total	**4,821**	**25,296**

Employment at PGNiG S.A. and the PGNiG Group as at June 30th 2016 by education (no. of staff)

	PGNiG S.A.	PGNiG Group
Primary	202	900
Secondary	2,320	14,102
Tertiary	2,299	10,294
Total	**4,821**	**25,296**

Employment at PGNiG S.A. and the PGNiG Group as at June 30th 2016 by length of service (no. of staff)

	PGNiG S.A.	PGNiG Group
Less than 1 year	99	841
1-3	247	1,803
4-10	1,483	6,246
11-14	289	1,337
15 years and more	2,703	15,069
Total	**4,821**	**25,296**

2. GOVERNING BODIES OF THE PARENT

2.1. Management Board

As at January 1st 2016, the composition of the PGNiG Management Board was as follows:

- Piotr Woźniak – member of the Supervisory Board delegated to temporarily perform the duties of President of the Management Board
- Waldemar Wójcik – Vice President.

At its meeting on February 10th 2016, the PGNiG Supervisory Board appointed the following persons to the PGNiG Management Board, with effect from February 11th 2016, for a joint term of office ending on December 30th 2016:

- Piotr Woźniak – President
- Janusz Kowalski – Vice President, Corporate Affairs
- Łukasz Kroplewski – Vice President, Development
- Bogusław Marzec – Vice President, Finance
- Maciej Woźniak – Vice President, Trade.

As at June 30th 2016, the composition of the PGNiG Management Board was as follows:

- Piotr Woźniak – President
- Janusz Kowalski – Vice President, Corporate Affairs
- Łukasz Kroplewski – Vice President, Development
- Bogusław Marzec – Vice President, Finance
- Maciej Woźniak – Vice President, Trade
- Waldemar Wójcik – Vice President.

Until the date of this report, there were no changes in the composition of the PGNiG Management Board.

2.2. Supervisory Board

As at January 1st 2016, the PGNIG Supervisory Board was composed of nine persons, including:

- Grzegorz Nakonieczny – Chairman
- Magdalena Zegarska – Secretary
- Wojciech Bieńkowski – Member
- Sławomir Borowiec – Member
- Mateusz Boznański – Member
- Andrzej Gonet – Member
- Krzysztof Rogala – Member
- Ryszard Wąsowicz – Member.
- Piotr Woźniak – Member of the Supervisory Board delegated to temporarily perform the duties of President of the Management Board of PGNiG S.A.

On January 7th 2016, the PGNiG Supervisory Board appointed Mr Wojciech Bieńkowski as Deputy Chairman of the PGNiG Supervisory Board.

The PGNiG Management Board and the PGNiG Supervisory Board accepted Mr Piotr Woźniak's resignation from his position of Member of the PGNiG Supervisory Board as of February 10th 2016.

On February 25th 2016, Mr Krzysztof Rogala tendered his resignation as Member of the PGNIG Supervisory Board.

On April 1st 2016, the Minister of State Treasury appointed Ms Anna Wellisz to the Supervisory Board.

On June 28th 2015, the Annual General Meeting of PGNiG removed Mr Grzegorz Nakonieczny from the Supervisory Board and appointed Mr Bartłomiej Nowak and Mr Piotr Sprzączak to the Supervisory Board.

As at June 30th 2016, the composition of the PGNiG Supervisory Board was as follows:

- Wojciech Bieńkowski – Deputy Chairman
- Magdalena Zegarska – Secretary
- Sławomir Borowiec – Member
- Mateusz Boznański – Member
- Andrzej Gonet – Member
- Bartłomiej Nowak – Member
- Piotr Sprzączak – Member
- Ryszard Wąsowicz – Member
- Anna Wellisz – Member.

<u>Changes subsequent to the end of the reporting period</u>

On July 27th 2016, the PGNIG Supervisory Board appointed Mr Bartłomiej Nowak as Chairman of the Supervisory Board, previously Member of the Supervisory Board.

3. SHAREHOLDERS

3.1. Shareholding structure

As at June 30th 2016, the share capital of PGNiG S.A. amounted to PLN 5,900,000,000 and was divided into 5,900,000,000 shares with a par value of PLN 1 per share. The Polish State Treasury was the only shareholder with a large direct holding of PGNiG shares. The shares of all series, i.e. Series A, A1 and B, were ordinary bearer shares and each share conferred the right to one vote at the General Meeting. The shareholding structure of PGNiG S.A. as at June 30th 2016 is presented in the table below.

Shareholding structure

Shareholder	Number of shares as at Jun 30 2016	% ownership interest as at Jun 30 2016	Number of voting rights conferred by shares held	% of total voting rights at GM as at Jun 30 2016
State Treasury	4,153,706,157	70.402%	4,153,706,157	70.402%
Other shareholders	1,746,293,843	29.598%	1,746,293,843	29.598%
Total	5,900,000,000	100.00%	5,900,000,000	100.00%

<u>PGNiG shares and shares in PGNiG S.A.'s related entities held by management and supervisory personnel</u>

On April 22nd 2016, a Member of the PGNiG Management Board sold 19,500 PGNiG shares on the regulated market, at PLN 5.20 per share.

In H1 2016, the holdings of PGNiG shares by the management and supervisory personnel did not change; they are presented in the table below.

PGNiG shares held by the management and supervisory personnel

Name	Position	Number of shares as at Dec 31 2015	Par value of shares as at Dec 31 2015 (PLN)	Number of shares as at Jun 30 2016	Par value of shares as at Jun 30 2016 (PLN)
Waldemar Wójcik	Vice President of the Management Board	19,500	19,500	-	-
Ryszard Wąsowicz	Member of the Supervisory Board	19,500	19,500	19,500	19,500

<u>Changes subsequent to the end of the reporting period</u>

On July 29th 2016, the PGNiG Management Board made a decision to repurchase and cancel some of the Company shares and submitted a relevant proposal to the General Meeting. The total purchase price of own shares may not exceed PLN 750m, and the buy-back will be financed with distributable funds, within the meaning of Art. 348.1 of the Commercial Companies Code. The repurchase of shares is to be completed by December 31st 2016. The PGNiG Management Board will define detailed terms and conditions of the buy-back at a later time and will publish them forthwith. Further, in the Management Board's assessment, the maximum amount of funds allocated to the buy-back does not exceed the Company's financing capabilities and takes account of its liquidity needs. An Extraordinary General Meeting has been convened for August 25th 2016 to consider the matter.

4. OPERATING REVIEW OF THE PGNIG GROUP

In H1 2016, the PGNiG Group reported revenue of PLN 17bn, 80% of which was derived from sales of natural gas.

Revenue (PLNm)

	H1 2016	H1 2015	H1 2014	H1 2013	H1 2012
Natural gas, including:	13,941	17,135	12,496	13,585	12,274
- high-methane gas	13,212	16,362	11,771	12,811	11,559
- nitrogen-rich gas	729	773	725	774	715
LNG	160	17	29	29	24
Crude oil, condensate and NGL	785	1,096	1,605	1,102	594
Helium	36	37	82	92	66
Electricity	874	765	866	552	445
Heat	676	625	582	601	527
Geophysical and geological services	91	65	129	107	161
Drilling and well services	101	133	255	288	260
Construction and assembly services	41	76	68	107	51
Distribution services	364	112	17	11	4
Connection charge	50	49	45	38	42
Other sales	230	280	207	228	316
Total	**17,349**	**20,390**	**16,381**	**16,740**	**14,764**

The tables below present natural gas and crude oil production volumes, electricity and heat generation volumes, as well as sales volumes for those products.

Output of key products

	Unit of measure	H1 2016	H1 2015	H1 2014	H1 2013	H1 2012
Natural gas	mcm	2,261	2,294	2,315	2,264	2,164
Crude oil, condensate and NGL	'000 tonnes	676	704	632	462	217
Electricity	GWh	2,329	2,311	2,382	2,512	2,403
Heat	TJ	21,633	21,040	20,924	24,471	23,415

Sales of key products

	Unit of measure	H1 2016	H1 2015	H1 2014	H1 2013	H1 2012
Natural gas	mcm	12,738	12,525	8,214	8,775	7,899
- Trade and Storage	mcm	12,299	12,138	7,826	8,407	7,534
- Exploration and Production	mcm	439	387	388	368	365
Crude oil, condensate and NGL	'000 tonnes	742	720	659	448	222
Electricity	GWh	5,435	4,812	5,267	2,139	2,036
Heat	TJ	21,461	20,867	20,770	24,277	23,224

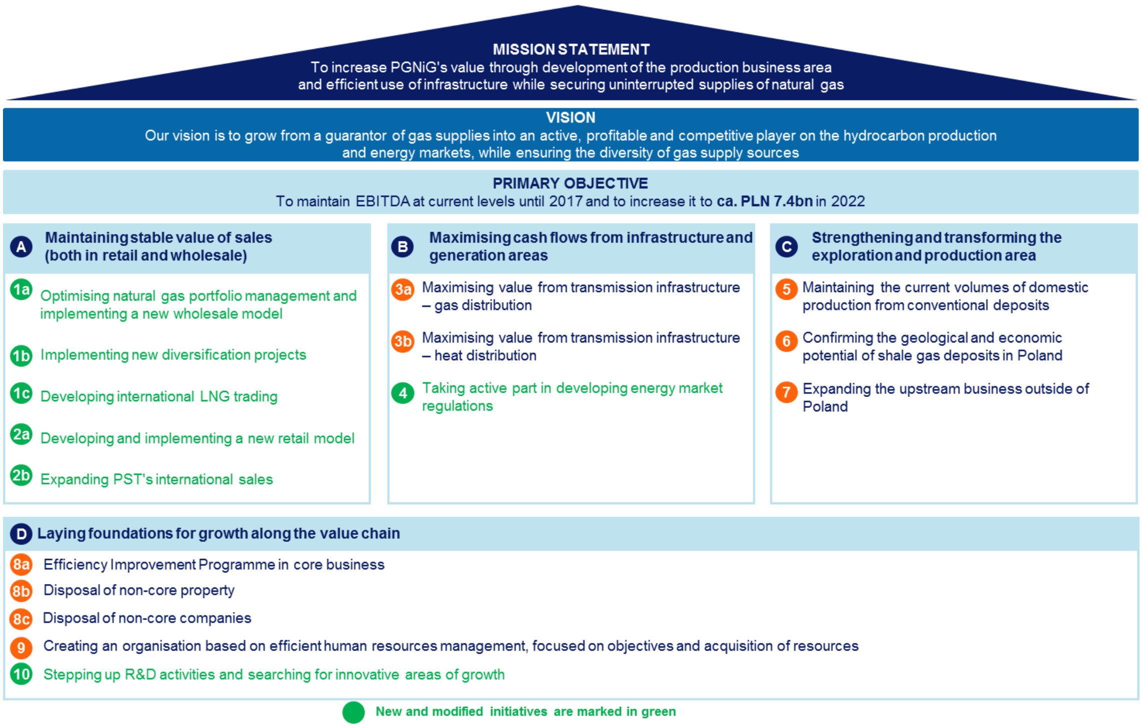
5. GENERAL DEVELOPMENT OF BUSINESS OF THE PGNIG GROUP

On April 4th 2016 the Supervisory Board of Polskie Górnictwo Naftowe i Gazownictwo S.A. approved the updated “Strategy of the PGNiG Group for 2014−2022” (“the Strategy”). The need for a review and update of the Strategy arose in view of the changing market conditions, and in particular the significant volatility of oil and gas prices in the global markets as well as pending deregulation of the Polish gas market.

As a result of the update, the number of strategic projects to be pursued until 2022 increased; their implementation should enable the Group to generate an EBITDA of about PLN 7.4bn in 2022 (the increase is attributable, among other things, to the Group’s growing aspirations in the area of gas and heat distribution infrastructure). In the period covered by the Strategy, capital expenditure on organic growth and acquisitions is maintained at PLN 40bn−50bn. The net debt to EBITDA ratio is expected to stay below 2.0 in 2022 and the current dividend policy is to be continued. In terms of operational objectives, it is of key importance that the planned rates of hydrocarbon production in Poland and abroad be increased to approx. 55−60 million boe in 2022 (by taking advantage of market conditions conducive to cost-effective acquisitions) and that the annual production targets in Poland be maintained at approx. 33 million boe.

The updated Strategy continues to focus on the following four key business areas:

- maintaining stable trading volumes (both retail and wholesale),
- maximising cash flows from the infrastructure and generation area,
- strengthening and transforming the exploration and production area,
- laying foundations for growth along the value chain.



<u>Maintaining stable trading volumes (both retail and wholesale)</u>

In the trading area, the PGNiG Group focuses particularly on investigating possibilities for diversifying sources of natural gas supply beyond 2022 and on analysing projects that would be required to support such diversification. As part of steps taken to secure PGNiG’s position with respect to gas supplies, a decision was made in May 2016 to purchase LNG on the spot market. The first shipment reached the LNG Terminal in Świnoujście on June 25th 2016: approximately 140 tcm of LNG (84 mcm of mains gas) was supplied from the Norwegian port of Melkøya. The Group intends to purchase LNG on a spot basis in addition to receiving regular deliveries under its long-term contract with Qatar

Liquefied Gas Company Limited. Spot purchases of LNG allow the PGNiG Group to diversify its gas supply sources and to effectively optimise its procurement portfolio. Having reserved 65% of the Świnoujście Terminal's capacity, PGNiG became a participant of the global LNG market.

As its next step, on June 28th 2016 PGNiG set up an LNG trading office in London, Europe's largest LNG trading hub. The office is to open for business in January 2017 and will reach its full operational capacity by the end of Q1 2017.

PGNiG has also taken steps to bring its long-term contract with OOO Gazprom eksport in line with the current conditions on the European natural gas market. On February 1st 2016, the Company filed a claim against PAO Gazprom and OOO Gazprom eksport in the arbitration proceedings instigated before the Arbitration Court in Stockholm. The pending proceedings do not preclude the parties from holding commercial negotiations to reach an agreement.

Concurrently, PGNiG seeks to maintain its leading position on the gas market and to remain the preferred gas supplier across all customer segments. In its proactive approach, the Company is adapting its product offering to the conditions on the liberalised market. The first half of 2016 proved that a strategy based on proposing a vast array of dedicated discount offerings, particularly in the business customer segment, is legitimate. Clients value the discount programmes proposed by the Company. The promotions and products offered to our clients enable us to build lasting partnership-based relations with the clients. It is also our objective to diversify our gas sales channels and to increase our engagement in the OTC market. In view of the foregoing, on June 17th 2016 we opened our first CSO Premium customer service office, and on July 1st 2016 we started to sell gas via the InfoEngine brokerage platform, which will contribute to improving liquidity of the gas market in Poland.

<u>Maximising cash flows from the infrastructure and generation area</u>

Our strategy for gas distribution assumes increasing the volume of distributed gas and the number of new customers, and a meaningful increase in the number of communes and municipalities connected to the gas distribution network across the country. Our primary goal for the following periods will be to extend service to unserved regions on Poland's gas distribution map. By 2022, Polska Spółka Gazownictwa (PSG) intends to roll out its gas network into 74 communes and municipalities and connect approximately 350,000 new customers. The organisational structure of PSG will also change to reflect the country's administrative division, which will simplify cooperation with local governments and make clients' access to the distribution company's services easier.

In H1 2016, the PGNiG Group consistently pursued activities aimed at increasing its share in the heat production and distribution market. To this end, on April 28th 2016 PGNiG TERMIKA S.A. purchased 100% of shares in Przedsiębiorstwo Energetyki Cieplnej S.A. of Jastrzębie Zdrój (PEC Jastrzębie S.A.). PEC Jastrzębie S.A. operates in highly promising heat markets of Upper Silesia, where the Group sees potential for growth already in a short-term horizon. The transaction strengthens our foothold in the district heating market. Another step in the PGNiG Group's Strategy of acquiring heating systems was an offer, submitted by PGNiG TERMIKA on April 28th 2016, to acquire shares in Spółka Energetyczna Jastrzębie S.A. (SEJ) from Jastrzębska Spółka Węglowa S.A. SEJ's business consists in generation of electricity and heat for Jastrzębska Spółka Węglowa's mines and other industrial customers, and generation of heat for households, which is distributed by PEC Jastrzębie S.A.

<u>Strengthening and transforming the exploration and production area</u>

In H1 2016, the Exploration and Production segment played a vital part in the operations and development of the PGNiG Group. The Group's main objective in this segment is to maintain stable production of natural gas and crude oil in Poland. In H1 2016, the PGNiG Group produced a total of 2,261 mcm of natural gas (high-methane gas equivalent), of which 1,949 mcm was produced from fields in Poland, and 312 mcm from fields abroad. In Poland the PGNiG Group also continued the exploration for and appraisal of shale gas deposits in its most promising licence areas, to verify its recoverable unconventional reserves of hydrocarbons and to commence their economically viable production in the shortest possible time. In H1 2016, the Group was involved in active exploration and production activities in its foreign licence areas (Norway and Pakistan).

Laying foundations for growth along the value chain

One of the goals of the Strategy is to transform the Company into one of the most innovative companies in the Polish energy sector. In H1 2016, the PGNiG initiated changes in its Research and Development (R&D) area. In particular, efforts were launched to formulate a new, extended R&D&I Strategy, i.e. a strategy covering research, development and innovation. The key objectives of the new R&D&I strategy include creating new tools to support innovativeness that would enable PGNiG S.A. to gain a meaningful presence at subsequent (post R&D) stages of the product life, i.e. commercialization and management of a mature innovative product. Concurrently, the Company has launched a project whose purpose is to formulate rules and define tools for successful engagement with startups in pursuit of the Company's strategic objectives. Work under this project will be aligned with efforts to operationalise and implement the R&D&I Strategy, planned for the third and fourth quarters of 2016.

In the area of human resources management, PGNiG S.A. focuses on development and retention of employees with high potential. Accordingly, on June 10th 2016 the Company launched a talent identification system that will help identify high-potential employees at PGNiG. Such individuals may become beneficiaries of a development programme that will prepare them to assume more responsible positions within the organisation, including managerial roles.

In H1 2016, the Group generated PLN 45m more cost savings than had been originally planned in the Strategy. The efficiency of the Group's organisation and processes has generated cumulative sustainable cost savings of PLN 765m since 2014.

6. REGULATORY ENVIRONMENT

6.1. Licences

As at June 30th 2016, PGNiG S.A. held the following licences granted by the President of the Energy Regulatory Office (the "President of URE") under the Energy Law:

- one licence to trade in gas fuels,
- one licence to trade in natural gas with foreign partners,
- one licence to trade in liquid fuels,
- one licence to produce electricity
- one licence to trade in electricity,
- one licence to liquefy natural gas and regasify LNG at LNG regasification plants.

PGNiG Obrót Detaliczny Sp. z o.o. held the following licences:

- one licence to trade in gas fuels, valid from April 25th 2014 to April 25th 2026,
- one licence to trade in electricity, valid from April 29th 2014 to April 29th 2026.

As at June 30th 2016, PGNiG S.A. held the following licences to conduct activities in Poland, granted under the Geological and Mining Law:

- 57 oil and gas exploration and appraisal licences,
- 226 oil and gas production licences,
- 9 licences for storage of gas in underground gas storage facilities (UGSF),
- 3 licences for storage of waste.

6.2. Changes of gas fuel tariffs

In H1 2016, the bulk of high-methane and nitrogen-rich natural gas sold by PGNiG S.A. and PGNiG Obrót Detaliczny Sp. z o.o. was subject to statutory price control. Only trade in high-methane natural gas on the Polish Power Exchange was exempt from the obligation to seek tariff approval.

Moreover, energy companies are not required to submit tariffs for approval by the President of URE with respect to trading in natural gas in liquefied form (LNG) and trading in compressed natural gas (CNG) used as fuel in motor vehicles.

<u>PGNiG S.A. tariff</u>

In H1 2016, PGNiG S.A. applied the following tariffs:

- from January 1st 2016 to March 31st 2016 – PGNiG Gas Fuel Supply Tariff No. 9/2016, approved by the President of URE on December 16th 2015; in the tariff, the average prices of high-methane gas and nitrogen-rich gas were reduced by 6.6% and 6.1%, respectively;
- from April 1st 2016 to June 30th 2016 – PGNiG Gas Fuel Supply Tariff No. 10/2016, approved by the President of URE on March 15th 2016; in the tariff, the average prices of high-methane gas and nitrogen-rich gas were reduced by 9.5% and 8.3%, respectively.

On June 14th 2016, the President of URE approved new PGNiG Gas Fuel Supply Tariff No. 11/2016 for the period July 1st 2016 − September 30th 2016. The average prices of high-methane gas and nitrogen-rich gas were reduced by 8.4% and 8.5%, respectively.

<u>PGNiG Obrót Detaliczny tariff</u>

In the period from January 1st 2016 to March 31st 2016, PGNiG Obrót Detaliczny Gas Fuel Trading Tariff No. 2, approved by the President of URE on December 17th 2015, was in effect. In the tariff, the average prices of gas fuel were reduced by:

- 3.3% for high-methane gas, including 3.5% for households (tariff groups W-1 to W-4) and 2% for business customers (the other tariff groups),
- 2.8% for nitrogen-rich gas (Lw),
- 2.1% for nitrogen-rich gas (Ls).

Subscription fees for households, excluding 12T tariff groups, were reduced by 10%. Subscription fees for other customers remained unchanged.

On March 15th 2016, the President of URE approved new PGNiG Obrót Detaliczny Gas Fuel Supply Tariff No. 3, effective from April 1st 2016 to June 30th 2016. In the tariff, the average prices of gas fuel were reduced by:

- 5.4% for high-methane gas, including 5.3% for households (tariff groups W-1 to W-4) and 6.8% for business customers (the other tariff groups),
- 6.1% for nitrogen-rich gas (Lw),
- 5.8% for nitrogen-rich gas (Ls).

Subscription fees remained unchanged.

On June 16th 2016, the President of URE approved new PGNiG Obrót Detaliczny Gas Fuel Supply Tariff No. 4, effective from July 1st 2016 to December 31st 2016. The average price of gas fuel was reduced by 1% across all tariff groups. Subscription and distribution fees remain unchanged.

The full text of the tariffs, prices and fees are available on www.oferta.pgnig.pl and www.ure.gov.pl.

Applications for exemption from the obligation to seek tariff approval

On February 19th 2013, the President of URE announced exemption of energy utilities holding gas fuel trading licences from the obligation to seek approval of wholesale gas trading tariffs. However, for the exemption to be effective, energy utilities must individually apply to the President of URE. PGNiG S.A. submitted such application to the President of URE. As at the date of this Report, the proceedings were pending.

In 2013, PGNiG S.A. applied to the President of URE for exemption from the obligation to seek approval for tariffs for high-methane natural gas (E) traded at a virtual gas trading point (OTC market). As at the date of this Report, the proceedings were pending.

On August 10th 2015, PGNiG S.A. applied to the President of URE for exemption from the obligation to seek approval for tariffs for the sale of high-methane natural gas to energy companies purchasing it for the purpose of natural gas transmission, distribution, storage, liquefaction or regasification activities. As at the date of this Report, the proceedings were pending.

On July 3rd 2015, PGNiG Obrót Detaliczny Sp. z o.o. applied to the President of URE for exemption from the obligation to seek approval for tariffs for high-methane natural gas (group E) traded at a virtual gas trading point (OTC market in Poland). As at the date of this Report, the proceedings were pending.

On January 26th 2016, PGNiG S.A. applied to the President of URE for exemption from the obligation to seek approval for tariffs for liquefied natural gas (LNG). The President of URE granted the exemption to PGNiG S.A. on February 3rd 2016.

6.3. Regulatory risks

Polish Energy Law

The Act Amending the Energy Law and Certain Other Acts (the so-called "Small Three Pack") of September 11th 2013 introduced the exchange sale requirement, i.e. the requirement to sell a specific portion of high-methane gas volumes fed into the transmission network in a given year on commodity exchanges. In the period September 11th–December 31st 2013, the exchange sale requirement applied to 30% of the overall gas volumes fed into the transmission network; in 2014, the proportion was 40%, and then, since January 1st 2015, it has been 55%. The requirement to sell gas on the exchange market, which now applies to PGNiG S.A., is aimed to deregulate the Polish gas market and support competition. The mechanism improves the market's transparency and allows market participants to purchase products on equal terms. On the other hand, it may cause PGNiG to gradually lose its market share. However, the actual rate at which PGNiG S.A.'s market share might shrink will depend on the number and size of new players entering the gas market and price differentials between prices offered by PGNiG S.A. and other market participants.

On June 23rd 2016, the Ministry of Energy published a draft amendment to the Energy Law, which provides for gradual deregulation of natural gas prices across customer groups. For more details, see *Deregulation* below.

Meeting the requirement to sell gas on the exchange market

Due to the low demand for gas on the exchange market, in 2013-2014 PGNiG S.A. failed to sell the required volume of gas on the exchange market. In order to ensure that the requirement is satisfied in the following years, a new company, PGNiG Obrót Detaliczny Sp. z o.o., commenced its operations in August 2014. Its business consisting in buying natural gas on the Polish Power Exchange and then selling it to customers. Accordingly, the volume of gas sold through the commodity exchange increased substantially, which enabled the Company to meet its obligation to sell the statutorily required level of 55% of gas through the exchange market in 2015. If this market trend continues, the regulatory risk of failure to meet the exchange sale requirement in the coming years is low.

The President of URE may impose financial penalties (of up to 15% of a non-complying entity's full-year revenue earned from the licensed activity in the preceding fiscal year) for its failure to sell the required volumes of gas through the exchange market in 2013 and 2014. Two proceedings were initiated in 2015.

On January 13th 2015, the President of URE instigated proceedings to impose a financial penalty on PGNiG S.A. for its failure to meet the obligation to sell gas through the exchange market in 2013. PGNiG S.A. filed an appeal with the Competition and Consumer Protection Court at the Regional Court of Warsaw against one of the interlocutory decisions made by the President of URE in the course of the proceedings. On April 15th 2016, the Regional Court of Warsaw – Court of Competition and Consumer Protection dismissed the appeal. On May 25th 2016 the President of URE ex officio resumed the proceedings to impose a fine on PGNiG S.A. for its failure to meet the exchange sale requirement in 2013. On June 17th 2016, acting under Art. 56.6a of the Energy Law, the Company filed a request that the President of URE refrain from imposing a penalty. As at the date of this report, the President of URE had not presented any position with respect to the Company's request.

On October 28th 2015, the President of URE instigated proceedings to impose a financial penalty on PGNiG S.A. for its failure to meet the obligation to sell gas through the exchange market in 2014. Having considered the evidence, on April 20th 2016, PGNiG S.A. filed a request under Art. 56.6a of the Energy Act that the President of URE refrain from imposing a penalty. On May 9th 2016, the President of URE imposed on the Company a fine of PLN 15,000,000 for its failure to meet the exchange sale requirement in 2014. The Company appealed against the decision. As at the date of this report, the Regional Court of Warsaw – Competition and Consumer Protection Court had not notified PGNiG S.A. of a hearing date.

Tariff calculation

Dependence of the PGNiG Group's revenue on tariffs approved by the President of URE is the key factor affecting the Group's regulated business. Tariffs are crucial to the Company's ability to generate revenue sufficient to cover its reasonable costs and deliver a return on the capital employed. Currently, the volume of that revenue depends on selling prices of gas fuel, which are regulated and result directly from the applied tariff calculation methodology. The tariff rules are defined in secondary legislation to the Energy Law, including mainly the Tariff Regulation. The methodology applied to determine tariffs consists in defining prices and charges at certain forecast costs and planned gas sales volumes, as a result of which revenue is subject to forecasting risk. Inaccurate estimates of demand for gas (affecting the accuracy of forecast purchase and supply volumes) and of costs applied to determine tariff prices and charges may adversely affect the financial performance of the PGNiG Group.

Deregulation

In connection with the ruling by the Court of Justice of the European Union of September 10th 2015 on the system of regulated gas fuel prices in Poland, changes must quickly be made to the regulations currently in effect. The CJEU ruled that the mandatory state intervention in Poland, obliging energy companies to charge natural gas delivery prices approved by the President of URE, without setting a time limit and regardless of customer groups (market segments), is non-compliant with EU regulations. The ruling was made in response to the European Commission's complaint against Poland concerning the regulation of gas prices in the country. The CJEU did not impose any fine on Poland for breach of the EU laws however, if Poland fails to make changes to its legal framework, the European Commission will again apply to the CJEU for imposing high financial penalties on Poland.

On June 23rd 2016, the Ministry of Energy published a draft "deregulation act" in the form of an amendment to the Energy Law. The key assumptions of the deregulation act include gradual lifting of regulated natural gas prices for individual customer groups. In light of the proposed draft, the following types of trade will be exempt from the obligation to seek tariff approval:

- from October 1st 2016 – sale of gas fuel to wholesalers and gas system operators, trading at a virtual trading point as well as under tender, auction or public procurement procedures; trading in LNG and CNG,
- from October 1st 2017 – sale of gas fuel to end customers other than households,
- from January 1st 2024 – sale of gas fuel to households.

The proposed amendment entails certain risks related to the need to adapt the gas fuel trading operations of the PGNiG Group to the new regulatory environment. The statutory deregulation of prices will require certain changes to be made in trading contracts to reflect the new regime. The deregulation of prices should also lead to an increase in the number of sellers in the natural gas market in Poland, resulting in stronger competitive pressures on the trading companies of the PGNiG Group.

On the other hand, bearing in mind that the PGNiG Group has gradually been abandoning tariffs in favour of market-driven prices, the deregulation will disperse the significant risk that the settlement prices charged to clients would be tariff-capped. In the present regulatory environment, prices of gas fuels defined in tariffs approved by the market regulator are defined as maximum prices, and remain fixed throughout the tariff period. This means that when prices determined on market terms are higher than the tariff prices, then the settlement prices are legally capped at the approved tariff level.

Act on Stocks of Crude Oil, Petroleum Products and Natural Gas

Meeting the statutory requirements related to mandatory stocks exposes PGNiG S.A. to balancing and technology risks, and threatens the performance of its contractual obligations.

The balancing risk is related to the Company's inability to meet peak demand for natural gas in autumn and winter months. This means that during longer spells of low temperatures, it may happen that – despite maximum gas supplies under long-term contracts, utilisation of available capacities at Western and Southern interconnectors, and gas withdrawal from underground storage facilities (remaining at the disposal of PGNiG S.A.) – the demand for gas will exceed the volumes which the Company is able to provide. Interconnector capacities are available to all market participants on equal terms. To note, allocation of mandatory stocks to the peak-demand storage facilities, i.e. to the Mogilno Cavern UGSF and the Kosakowo Cavern UGSF reduces the flexibility of supplies to the transmission system and limits PGNiG's ability to optimise its asset portfolio. Gas from mandatory stocks may be withdrawn only upon the Minister of Economy's consent and only after gas supply limits have been imposed on users consistent with relevant provisions of their supply contracts. Notwithstanding the above, withdrawal of gas from mandatory stocks results in a situation where users face gas supply limits despite high volumes of gas held in storage.

The technology risk follows from the fact that the need to maintain mandatory stocks has a negative impact on the operating parameters of underground storage facilities. In water-drive storage facilities, if gas is not withdrawn for longer periods of time gas withdrawal may become more difficult at the end of the withdrawal process, and may reduce the facility's withdrawal capacity in future operating cycles. Restoring the original operating parameters of a gas storage facility is a long-term process.

On July 22nd 2016, the Act Amending the Energy Law and Certain Other Acts was passed. With respect to the gas storage activities, the new act extends the list of entities required to maintain mandatory stocks of natural gas to include gas importers, and removes exemptions from the obligation to maintain mandatory stocks of natural gas previously enjoyed by utilities with fewer than 100 thousand customers and importing less than 100mcm of natural gas in a calendar year. The new act also enables entities obligated to maintain mandatory stocks of gas that have no storage capacities of their own to cover their obligation by transferring the obligation to another obligated entrepreneur on a contract basis (stockholding ticket). The amendments provide an equal playing field for all entities operating in the Polish gas market and may potentially increase demand for stockholding services.

Geological and Mining Law

In 2015, the Act Amending the Geological and Mining Law and Certain Other Acts, as well as the Act on the Special Hydrocarbon Tax, came into force. The Act Amending the Geological and Mining Law and Certain Other Acts introduced a new licensing system, including a system for converting a licence for exploration and appraisal into a licence covering also hydrocarbon production. Favourable as it is, in the transitional period (until the end of 2016) the change may significantly slow down the administrative processes of the licensing authority. The new Act also introduced higher royalty rates for hydrocarbon reserves other than marginal, effective as of January 1st 2016. The amended rates will adversely affect the financial performance of the PGNiG Group.

Energy Efficiency Act

On May 20th 2016, a new Energy Efficiency Act was passed; it transposes the provisions of Directive 2012/27/EU on energy efficiency, amending Directives 2009/125/EC and 2010/30/EU and repealing Directives 2004/8/EC and 2006/32/EC, into the Polish legal framework. The new Energy Efficiency Act will effect on October 1st 2016 and will introduce major changes regarding the manner of performing statutory obligations by energy utilities, which may result in such utilities incurring higher operating expenses. The most important of these include the necessity to implement energy efficiency improvement projects as the principal way to discharge the obligations, increase in the unit substitution fee, and the obligation to carry out energy audits of a company every four years (or, alternatively, to implement energy management systems to be exempted from the audit obligation).

The new legislation also changes the list of entities obligated to deliver energy savings. According to the new act, system participants will also include end users connected to the mains gas network in Poland who import gas for their own use. This change improves PGNiG S.A.'s competitive position by ensuring an equal playing field for all natural gas market operators competing in the Polish market.

7. EXPLORATION AND PRODUCTION

The segment comprises the entire process of oil and gas exploration and production in Poland and abroad, starting from geological analyses, through geophysical surveys and drilling work, to end with field development and hydrocarbon production. The work is conducted by the segment on its own or jointly with partners, under joint operations agreements.

Companies of the Exploration and Production segment: PGNiG S.A., PGNiG Upstream International AS, Polish Oil and Gas Company – Libya BV, GEOFIZYKA Kraków Sp. z o.o., GEOFIZYKA Toruń Sp. z o.o., EXALO Drilling S.A.

7.1. Exploration

In H1 2016, PGNiG S.A. was involved in crude oil and natural gas exploration and appraisal projects in the Carpathian Mountains, Carpathian Foothills and Polish Lowlands, both on its own and jointly with partners. In its licence areas in Poland PGNiG S.A. conducted drilling work at five exploration wells (Dargosław-1, Paruchów-1K, Wola Cewkowska-1, Dąbrowica Duża-6, Krobielewko-4K). In H1 2016, four exploration wells were classified as positive, including one well in the Polish Lowlands (Dargosław-1) and three in the Carpathian Foothills (of which two were drilled in 2015) (Słotwinka-1K, Rogoźnica-3K, Dąbrowica Duża-6). Two wells failed to yield a commercial flow of hydrocarbons and were abandoned (Paruchów-1K, Wola Cewkowska-1).

In H1 2016, the Dargosław-1 exploration well discovered a nitrogen-rich gas field in the town of Siemidarżno (Gryfice county) in the Province of Szczecin. Its deposits are estimated at 0.5–1 bcm, and the expected annual gas output is ca. 25 mcm.

7.2. Collaboration with other entities

In H1 2016, PGNiG S.A. conducted joint operations with other entities in licence areas awarded to PGNiG S.A., FX Energy Poland Sp. z o.o., LOTOS Petrobaltic S.A., and ORLEN Upstream Sp. z o.o. Furthermore, PGNiG S.A. collaborated with other entities in carrying out exploration work in Pakistan and Norway.

7.2.1. Collaboration in Poland

Under the licences awarded to PGNiG S.A., work continued in the following areas:

- "Płotki" – under the joint operating agreement dated May 12th 2000; licence interests: PGNiG S.A. (operator) – 51%, FX Energy Poland Sp. z o.o. – 49%;
- "Płotki" – "PTZ" (the Extended Zaniemyśl Area) – under the joint operating agreement dated October 26th 2005; licence interests: PGNiG S.A. (operator) – 51%, FX Energy Poland Sp. z o.o. – 24.5%, Calenergy Resources Poland Sp. z o.o. – 24.5%;
- "Poznań" – under the joint operating agreement dated June 1st 2004; licence interests: PGNiG S.A. (operator) – 51%, FX Energy Poland Sp. z o.o. – 49%;
- "Bieszczady" – under the joint operating agreement dated June 1st 2007; licence interests: PGNiG S.A. (operator) – 51%, Eurogas Polska Sp. z o.o. – 24%, and Energia Bieszczady Sp. z o.o. – 25%; on July 20th 2015, ORLEN Upstream Sp. z o.o. acquired a 49% interest in licence blocks 437, 438, 456, 457, 458 and in parts of licence blocks 416, 417 and 436 held by Eurogas Polska Sp. z o.o. and Energia Bieszczady Sp. z o.o., thus becoming a party to the joint operating agreement;
- "Sieraków" – under the joint operating agreement dated June 22nd 2009; licence interests: PGNiG S.A. (operator) – 51%, ORLEN Upstream Sp. z o.o. – 49%;
- "Kamień Pomorski" – under the agreement of August 14th 2013; licence interests: PGNiG S.A. (operator) – 51%, LOTOS Petrobaltic S.A. – 49%;
- "Górowo Iławieckie" – under the agreement on joint operations of December 31st 2014; licence interests: PGNiG S.A. (operator) – 51%, LOTOS Petrobaltic S.A. – 49%.

In the "Płotki" – "PTZ" area, work was continued on the decommissioning of the Zaniemyśl gas production facility. In the "Poznań" area, construction of the Karmin and Miłosław gas production facilities continued and preparatory work was conducted for drilling of the Miłosław-5K/H exploratory well. Also, drilling of the Paruchów-1K exploratory well was discontinued, as no hydrocarbon flow to the well was detected, and the well was decommissioned. In the "Bieszczady" area, the processing of 2D seismic data (Hoczew-Lutowiska) was completed. In the "Sieraków" area, preparatory work was continued to upgrade the Sieraków-1 well.

Under licences held by FX Energy Poland Sp. z o.o. work was conducted in the "Warszawa-Południe" area (block 255), under a joint operating agreement dated May 26th 2011. The licence interests are as follows: FX Energy Poland Sp. z o.o. (operator) – 51%, and PGNiG S.A. – 49%. In H1 2016, 3D seismic survey of Wilga-Potycz was carried out and processing of the acquired data began.

7.2.2. Collaboration abroad

Germany

Work was continued in a subdivision of the Lubben licence area in east Germany (Brandenburg) under a joint operating agreement of August 4th 2015. PGNiG's (36% interest) project partners are Central European Petroleum Gmbh (39% interest and operatorship) and Austria's Rohöl-Aufsuchungs AG (25% interest). In H1 2016, drilling of the Markische Heide-1 exploratory well was completed (due to a drilling failure not all planned measurements were made) and the analysis of the acquired data began. In May 2016, reprocessing of 3D seismic data was completed and its interpretation began in order to determine the possible prospect location.

Pakistan

PGNiG S.A. conducts exploration work in Pakistan under an agreement for hydrocarbon exploration and production in the Kirthar licence area executed between PGNiG S.A. and the government of Pakistan on May 18th 2005. Work in the Kirthar block is conducted jointly with Pakistan Petroleum Ltd., with production and expenses shared in proportion to the parties' interests in the licence: PGNiG S.A. (operator) – 70%, PPL – 30%.

As part of the joint development strategy for the Rehman and Rizq deposits, in H1 2016 drilling of the Rehman-2 well began. The drilling of the Rehman-3 well will commence as soon as work at the Rehman-2 well is completed. Work at both wells is expected to be completed by the end of 2016. In H1 2016, further gas pipeline construction work was performed to connect the Rizq-1, Rehman-2 and Rehman-3 wells to the production facility at the Rehman field. Also, preparatory work began for drilling of four new wells (two production wells, one appraisal well, and one exploration well). As part of further exploration and documentation work, work on a new 3D seismic survey was completed. The Company also continued production from the Rehman-1 and Hallel X-1 wells.

Norway

PGNiG Upstream International AS, a PGNiG Group company, holds interests in exploratory and production licences on the Norwegian Continental Shelf, in the Norwegian Sea, in the North Sea, and in the Barents Sea. Jointly with partners, the company has been producing hydrocarbons from the Skarv, Morvin, Vilje and Vale fields and working on the development of the Snadd and Gina Krog fields. In the other licence areas, the company is engaged in exploration projects.

PGNiG Upstream International AS's main asset is the Skarv field, which has been developed using a floating production, storage and offloading (*FPSO*) vessel. The FPSO is owned by the licence holders, including PGNiG Upstream International AS, and is expected to continue is operations for the next 20 years. Other fields (Morvin, Vilje and Vale) comprise a group of wells connected to the existing production infrastructure.

Crude oil is sold directly from the fields to Shell International Trading and Shipping Company Ltd (crude from the Skarv, Vilje and Vale fields) and to TOTSA TOTAL OIL TRADING S.A. (crude from the Morvin field). All fields except for Vilje also produce associated gas, which is transferred via a gas pipeline mainly to Germany, where it is collected by PGNiG Supply & Trading GmbH.

In H1 2016, the company produced a total of 297 thousand tonnes of crude oil with condensate and NGL (measured as tonnes of crude oil equivalent) and 287 mcm of natural gas from the Skarv, Morvin, Vilje, and Vale fields. Production from the deposits was higher than initially planned. Greater output was achieved mainly thanks to the high efficiency of the production facilities. In addition, the larger output from the Skarv field was achieved through the use of a technique of injecting natural gas into the deposit to improve oil recovery.

In H1 2016, PGNiG Upstream International AS and its partners continued the development of the Gina Krog and Snadd fields. In the Gina Krog field, drilling of exploration wells continued. At a shipyard in South Korea, construction of an oil and gas rig was completed. In August 2016, the rig is expected to be installed on a jacket and prepared for production launch. As regards the Snadd field, the field development concept was selected. The preferred scenario provides for drilling of three new exploration wells and launch of production in 2021.

Working jointly with its partners, PGNiG Upstream International AS also continued operations in its other exploration licence areas. Among other things, the company worked on the evaluation of prospectivity of the PL702, PL703, PL707, PL756 and PL799 licence areas. Having reviewed the results of geological and economic analyses, the Company and its partners decided to relinquish PL702 and PL756 licences with no wells drilled.

In H1 2016, further *APA* 2015 rounds (*Awards in Pre-defined Areas*) and the 23rd *Licence Round* were concluded, as a result of which PGNiG Upstream International AS was awarded interests in the following five new exploration licences:

- 40% interest (as the operator) in the PL838 licence area in the Norwegian Sea; the eastern side of the awarded acreage is located next to the Skarv field; the licence partners are Tullow Oil Norge AS and E.ON E&P Norge AS, with a 30% interest each;
- 11.9175% interest (as a partner) in the PL839 licence area in the Norwegian Sea; the licence operator is BP Norge AS (with a 23.8% interest), while the other partners are Statoil Petroleum AS (36.2%) and E.ON E&P Norge AS (28.1%);
- 8% interest (as a partner) in the PL813 licence area in the North Sea; the licence operator is Statoil Petroleum AS (with a 58.7% interest), while the other partners are Total E&P Norge AS (30%) and Det norske oljeselskap ASA (3.3%);
- 20% interest (as a partner) in the PL850 licence area in the Barents Sea; the licence operator is Edison Norge AS (with a 40% interest), while Lime Petroleum Norway AS and KUFPEC Norway AS are the other partners, with a 20% interest each;
- 25% interest (as a partner) in the PL856 licence area in the Barents Sea; the licence operator is Capricom Norge AS (with a 75% interest).

Within two years (or three in the case of the PL850 licence) the licence partners will perform relevant geological and geophysical investigations allowing them to make precise estimates of the hydrocarbon potential of the licences. After those periods, drill-or-drop decisions will be made.

As at June 30th 2016, PGNiG Upstream International AS held interests in 18 exploration and production licences on the Norwegian Continental Shelf, including in two licences as the operator.

Libya

Due to the tense political situation and the growing threat to the security of employees, Polish Oil and Gas Company - Libya B.V., the Group's subsidiary, discontinued its exploration activities in Libya in January 2014. Previously, it had conducted exploration work in licence area No. 113 within the Murzuq petroleum basin in Libya, under the exploration and production sharing agreement of February 25th 2008 concluded with the Libyan government.

7.3. Production

In H1 2016, the PGNiG Group produced oil and gas from hydrocarbon-bearing formations in Poland, in the Norwegian Continental Shelf, and in Pakistan. Natural gas and crude oil in Poland is extracted by two branches of PGNiG S.A.: the Zielona Góra Branch and the Sanok Branch. The Zielona Góra Branch produces crude oil and nitrogen-rich natural gas at 21 sites, including 12 gas production facilities, 6 oil and gas production facilities and 3 oil production facilities. The Sanok Branch produces high-methane and nitrogen-rich natural gas and crude oil at 36 sites, including 18 gas production facilities, 13 oil and gas production facilities and 5 oil production facilities.

In H1 2016, the PGNiG Group produced a total of 2,261 mcm of natural gas (high-methane gas equivalent), of which 1,949 mcm was produced from fields in Poland, and 312 mcm from fields abroad. Production of crude oil and NGL reached 676 thousand tonnes of crude oil equivalent, of which 297 thousand tonnes came from the Norwegian Continental Shelf. Natural gas and crude oil production volumes are presented in the tables below.

Natural gas production volume

	H1 2016		H1 2015	
	GWh	mcm	GWh	mcm
High-methane natural gas, including:	10,922	995	11,054	1,007
- Zielona Góra Branch	0	0	0	0
- Sanok Branch	7,768	708	8,000	729
- Norway	3,154	287	3,054	278
Nitrogen-rich gas, including:	13,891	1,266	14,123	1,287
- Zielona Góra Branch	13,285	1,211	13,454	1,226
- Sanok Branch	330	30	375	34
- Pakistan Branch	276	25	294	27
Total	**24,813**	**2,261**	**25,177**	**2,294**

Crude oil production volume

	Unit of measure	H1 2016	H1 2015
Zielona Góra Branch	'000 tonnes	357	331
Sanok Branch	'000 tonnes	22	23
Norway	'000 tonnes	297	350
Total	**'000 tonnes**	**676**	**704**

In H1 2016, in the PGNiG Sanok Branch area, production was launched from two new fields: Draganowa and Siedleczka (test production), and three wells on producing fields were hooked-up (Lubliniec-13, Rzeszów-20K and Pruchnik-27). The total addition to production capacity was approximately 3.6 thousand cubic metres of gas per hour (high-methane gas equivalent).

In the PGNiG Zielona Góra Branch area, production commenced from one new field, Połęcko (test production). The total addition to production capacity was 80 tonnes of crude oil per day.

Underground gas storage facilities

In H1 2016, the Exploration and Production segment used the working capacities of the Daszewo and Bonikowo nitrogen-rich gas storage facilities. Storage capacities used to meet the needs of the Production segment are not storage facilities within the meaning of the Polish Energy Law. The table below presents the working capacities of the underground storage facilities used by the Exploration and Production segment as at June 30th 2016.

Working capacities of the underground storage facilities used by the Exploration and Production segment

Nitrogen-rich gas	GWh*	mcm
Daszewo (Ls)	250	30
Bonikowo (Lw)	1,667	200

*Converted to gas with a calorific value of 30 MJ/cm

7.4. Sales of key products

The main products sold by the Trade and Storage segment are crude oil, high-methane gas and nitrogen-rich gas. Other products, obtained in the process of crude refining, include crude condensate, sulfur, and propane-butane. Some of the produced nitrogen-rich gas is further treated into high-methane gas at the Odolanów and Grodzisk Wielkopolski nitrogen rejection units. Apart from high-methane gas, the cryogenic processing of nitrogen-rich gas yields such products as liquefied natural gas (LNG), gaseous and liquid helium, and liquid nitrogen.

In H1 2016, the segment sold 439 mcm of gas, of which 392 mcm was sold on the domestic market and 47 mcm on foreign markets. The segment also sold 734 thousand tonnes of crude oil, including other fractions. The tables below present volumes of natural gas sold directly from the fields (measured as high-methane gas equivalent), and volumes of crude oil and NGL sold.

Sales of natural gas

	H1 2016		H1 2015	
	GWh	mcm	GWh	mcm
High-methane gas	487	44	408	37
Nitrogen-rich gas	4,321	395	3,839	350
Total	**4,808**	**439**	**4,247**	**387**

Sales of crude oil with condensate, produced in Poland

	Unit of measure	H1 2016	H1 2015
Sales in Poland	'000 tonnes	267	252
Sales abroad	'000 tonnes	110	113
Total	'000 tonnes	377	365

Sales of crude oil with condensate and NGL, produced on the Norwegian Continental Shelf

	Unit of measure	H1 2016	H1 2015
Norway	'000 tonnes	357	355

In Poland, the largest amounts of natural gas were sold to industrial customers, accounting for about 75% of the total sales volume. In crude oil trading, the PGNiG Group continued its policy of trading with the largest Polish and foreign entities in the fuel sector. PGNiG S.A. sold crude oil to Shell International Trading and Shipping Company Ltd., TOTSA TOTAL OIL TRADING S.A., ORLEN Południe S.A. and Grupa LOTOS S.A.

7.5. Service activities

In H1 2016, the Exploration and Production companies were engaged in drilling exploration, appraisal, core and production boreholes, and provided specialist well and geophysical services.

Exploration, appraisal and core boreholes were drilled mainly in search for hydrocarbons, but also for copper and other solid minerals. Drilling services were provided both to the PGNiG Group and to external customers. Drilling work abroad was performed mainly for external customers exploring for oil and gas in conventional formations, e.g. in Kazakhstan and Pakistan. The main customer in Poland was PGNiG S.A. In Poland, contracts were performed for companies exploring for oil and gas in conventional formations (e.g. PGNiG S.A., Rawicz Energy Sp. z o.o.), and as part of projects aimed at appraisal of copper and other solid mineral deposits, for KGHM Polska Miedź S.A., Miedź Copper Sp. z o.o., Zielona Góra Copper Sp. z o.o., Przedsiębiorstwo Budowy Kopalń PeBeKa S.A., Mozów Copper Sp. z o.o., and Wilcze Copper Sp. z o.o. Production well drilling was performed mainly in Poland, for PGNiG S.A. Abroad, such work was performed for external customers, mainly in Pakistan.

The segment companies also provided specialist well services, such as drilling fluid services, cementing services, coiled tubing and nitrogen unit operations, mud logging, sampling, downhole equipment and well testing services, reservoir measurements and production tests, as well as remedial treatments, workovers, and well abandonment services. These well services were primarily performed for PGNiG S.A. In Poland, the main third-party customers for well services included KGHM Polska Miedź S.A., Zielona Góra Copper Sp. z o.o., Mozów Copper Sp. z o.o. and Przedsiębiorstwo Budowy Kopalń PeBeKa S.A., while abroad coiled tubing operations, cementing and other services were performed for customers in Ukraine.

In H1 2016, the Exploration and Production segment performed exploration geophysics (including seismic data acquisition, processing and interpretation) and well logging services. In Poland, the key customer was PGNiG S.A., but services were also provided to FX Energy Poland Sp. z o.o. and Orlen Upstream Sp. z o.o. The services included both exploration geophysics and well logging services. On foreign markets, the segment focused on the provision of exploration geophysics services, mainly for customers in Egypt, Italy, Morocco and Pakistan.

7.6. Planned activities

Exploration activities in Poland

In H2 2016, PGNiG S.A. will carry out exploratory geophysical work and drilling in Poland on a number of prospects in the Carpathian Mountains, Carpathian Foothills and the Polish Lowlands. The work will be conducted by PGNiG S.A. on its own or jointly with partners.

The Company also intends to pursue projects focused on exploring new opportunities, where little appraisal has been made so far. In Pomerania, fracturing is to be continued in two wells drilled in 2015 (Wysin-2H and Wysin-3H). The Company also plans to stimulate gas flow in the existing coal bed methane wells (Gilowice-1 and Gilowice-2H) in Upper Silesia. Results of the stimulation efforts are expected to be known by the end of 2016.

Exploration activities on foreign markets

In H2 2016, in Pakistan PGNiG S.A. will continue drilling the Rehman-2 well and will commence drilling the Rehman-3 well. In the following years, under the Kirthar licence, the Company will perform work to gradually expand the capacity of the production installations; further drilling work will also be performed on the Rehman and Rizq fields. In addition, PGNiG S.A. plans to continue exploration work within three potential fields: N2, W1 and W2.

In a subdivision of the Lubben licence in east Germany the Company will continue work on interpretation of 3D seismic data.

On the Norwegian Continental Shelf, PGNiG Upstream International AS, as a project partner, will continue to produce hydrocarbons from the Skarv, Morvin, Vilje and Vale fields and will proceed with the development of the Snadd and Gina Krog fields. The company will also work towards ensuring stable, predictable and long-term gas supplies to Poland. These efforts will include analysis of infrastructure scenarios for actual transmission of Norwegian gas to the country. PGNiG Upstream International AS also intends to acquire new licence areas by participating in the APA annual licensing rounds and in the regular licensing rounds held every two to three years. The company may seek to acquire new licence areas through farm-in (purchase of interests from other companies) or farm-down (exchange of interests with other companies) arrangements. PGNiG Upstream International AS holds a diversified portfolio of production as well as exploration and production licences in the North Sea, the Norwegian Sea and the Barents Sea, and maintaining this diversification is perceived as an important factor in managing the project portfolio. In the future, the company may participate, as a partner, in drilling projects in deep-sea waters (below 1,000 metres) and in the Arctic Zone through its interests in the PL703 licence in the Vøring Basin in the Norwegian shelf, where the sea depth exceeds 1,000 metres, and in three licences (PL707, PL850 and PL 856) in the Barents Sea.

Production of hydrocarbons

In 2016, the PGNiG Group will be engaged in production of hydrocarbons in Poland, in the Norwegian Continental Shelf, and in Pakistan. The Group is implementing an investment programme to maintain its long-term natural gas production capacity. As part of the programme, the PGNiG Group plans to develop new deposits and wells, modernise and expand the existing gas production facilities, build new underground gas storage facilities, and expand the existing ones.

The volume of gas production planned for 2016 is approximately 4.7 bcm of high-methane gas equivalent with a calorific value of 39.5 MJ/m^3, of which 4.1 bcm will be produced from fields in Poland, 0.5 bcm from fields in the Norwegian Continental Shelf, and 0.1 bcm from fields in Pakistan. The Group also plans to produce 1.2 million tonnes of crude oil with condensate, including 0.77 million tonnes in Poland and 0.43 million tonnes from fields in the Norwegian Continental Shelf.

It is expected that by the end of 2016 in the Sanok Branch area production will be launched from the new Markowice field and a number of wells will be hooked-up in the Przemyśl, Przeworsk, Lubliniec, and Smolarzyny fields. In the Zielona Góra Branch area, production is to be launched from two new fields: Gajewo and Karmin (in partnership with ORLEN Upstream Sp. z o.o.) and from a well in the Brońsko field.

Service activities

In 2016, the PGNiG Group plans to provide drilling services in Poland and abroad. In Poland, drilling services will be performed for PGNiG S.A. and third-party customers, including Orlen Upstream Sp. z o.o., Zielona Góra Copper Sp. z o.o., and Palomar Natural Resources LLC. On foreign markets, the Group will perform drilling work for its existing and new customers in Kazakhstan and Pakistan. As economic conditions improved in Ukraine (changes in tax law), the Group intends to re-launch its operations in that market.

Specialist well services are planned to be performed in Poland chiefly for PGNiG S.A., but also for foreign companies that hold licences to explore for minerals (mainly hydrocarbons), and in foreign markets for third-party customers in Slovakia, Ukraine, Hungary, the Czech Republic, Uzbekistan, Iran and other countries.

The segment will also provide seismic data acquisition, processing and interpretation services as well as and well logging services for PGNiG S.A. and external customers. On foreign markets, the PGNiG Group plans to provide geophysical services in Morocco, Pakistan, India, Mozambique, Algeria, Germany, Spain, Egypt, Tunisia, Myanmar, Italy and other countries.

7.7. Risks related to exploration and production

Resource discoveries and estimates

The main risk inherent in exploration activities is the risk of failure to discover reserves, i.e. exploration risk. This means that not all identified leads and prospects actually have deposits of hydrocarbons which can qualify as an accumulation.

Reserves estimates and production projections may be erroneous due to imperfections inherent in the applied equipment and technology, which affect the quality of the acquired geological information. Irrespective of the methods applied, data on the volume and quality of commercial reserves of crude oil and natural gas is always an estimate. Actual production, income and expenses relating to a given deposit may significantly differ from the estimates. The weight of this risk is further increased by the fact that in the full business cycle the period from start of exploration to the launch of production from a developed field takes six to eight years, while the production lasts from 10 to 40 years. Formation characteristics determined at the stage of preparing the relevant documentation are reviewed after production launch. Any downward revision of the size of deposits or production volumes may lead to lower revenues and adversely affect the PGNiG Group's financial performance.

Exploration for unconventional deposits of gas

The risk associated with exploration for unconventional deposits of gas in Poland relates to the lack of confirmed presence of *shale gas* and *tight gas*. But even if existence of in-place hydrocarbons is confirmed, production may prove uneconomic due to insufficient recovery rates and high investment expenditure necessary to drill wells and construct production facilities. Another material factor is the difficulty of accessing unconventional gas plays given the environmental regulations and the requirement to obtain the landowners' consent for access to the area.

Delayed work

Under the applicable Polish laws and regulations, the process of obtaining a licence for exploration and appraisal of crude oil and natural gas reserves lasts from one to one and a half years. In foreign markets such procedures may even take up to two years from the time the winning bid is awarded until the actual contract is ratified. Prior to the commencement of field work, the Company is also required to make a number of arrangements, for instance to obtain legal permits and approvals for entering the area, and to meet the environmental protection requirements and, in some cases, requirements related to the protection of archaeological sites. It is also required to hold tenders to select a contractor. All this delays the execution of an agreement with the contractor by another few months. Frequently the waiting time for customs clearance of imported equipment is very long. All these factors create the risk of delays in the start of exploration work.

Formal and legal hurdles beyond PGNiG S.A.'s control include:

- local governments' failure to approve local zoning plans or amendments to those already approved;
- obstacles in having investment projects incorporated into the local zoning plans;
- requirement to obtain and comply with administrative or other formal and legal decisions, including environmental decisions or building permits;
- amendments to the investment project;
- obstacles in obtaining permission from land owners to enter the site.

These factors significantly delay launch of investment projects and start of on-site construction work. Further, PGNiG S.A.'s obligation to comply with the Public Procurement Law frequently protracts the tender procedure. Notices of appeal and complaints submitted by bidders lead to lengthy court proceedings and, consequently, to delays in implementing an entire project. A protracting project exacerbates the risk related to estimation of capital expenditure.

Cost of exploration

Capital intensity of an exploration project depends on prices of energy carriers and materials. Cost of exploratory work is especially sensitive to steel prices, which are passed onto prices of casing pipes and lifting casing used in drilling. An increase in prices of energy and materials translates into higher costs of exploratory work. Profitability of foreign exploration projects also depends to a significant extent on prices of oil derivative products and on exchange rates. To reduce the cost of drilling operations, in 2011 PGNiG S.A. changed its drilling contractor selection procedure by moving away from the turnkey contract system and introducing a rate-based system, with daily rates being the most commonly used.

Competition

Both in Poland and abroad there is a risk of competition from other companies seeking licences for exploration for and appraisal of hydrocarbon deposits. Certain competitors of the PGNiG Group, especially global players, enjoy strong market positions and have greater financial resources than those available to the Group. Thus, it is probable that such companies would submit their bids in tender procedures and be able to acquire promising licences, offering better terms than the Group could offer given its financial and human resources. This competitive advantage of oil majors is particularly important on the international market.

Political and economic situation in the regions where the PGNiG Group operates

In some countries where the PGNiG Group conducts exploration activities there is a number or risks, which may lead to limitation, suspension or even discontinuation of the exploration and production activities. These risks include armed conflicts, terrorist attacks, social or political unrest, internal conflicts, and civil disturbance.

In 2011, all non-Libyan employees of POGC-Libya B.V. were evacuated from the country following the occurrence of a force majeure event. Operations were resumed in the second half of 2012. A similar situation occurred in January 2014. All Polish employees working in the Murzuq 113 licence area were evacuated from the site and returned to Poland. The site was sealed and secured by Libyan government forces and was left to be overseen by local subcontractors.

In Pakistan, in 2014 PGNiG S.A. had to declare a force majeure event and suspend work on the Rizq-1 exploratory well on two occasions due to armed attacks in the region. Work on Rizq-1 was resumed in December 2014.

In certain countries, operations of exploration companies may be hindered by the absence of adequate infrastructure, which may be an obstacle in transporting equipment, personnel and materials to the sites. Also, frequent changes in national legislation may lead to suspending or limiting the scope of exploration activities.

Unforeseen events

Hydrocarbon deposits developed by the PGNiG Group are usually located at great depths, which involves extremely high pressures and, in many cases, the presence of hydrogen sulfide. Consequently, the risk of hydrocarbon blowout or leakage is very high, which in turn may pose a threat to people (employees and local population), natural environment and production equipment.

The PGNiG Group and its partners are engaged in exploration for and production of hydrocarbons on the Norwegian Continental Shelf. Offshore operations are much more complicated than those carried out onshore. If a serious failure or uncontrolled release of hydrocarbons occurs at sea, remediation can be very costly.

Safety, environmental protection and health regulations

Ensuring compliance with environmental laws in Poland and abroad may significantly increase PGNiG S.A.'s operating expenses. Currently, PGNiG S.A. incurs significant capital expenditure and costs on ensuring compliance of its operations with ever more complex and stringent regulations concerning safety and health at work, as well as environmental protection. The act of May 18th 2005 amending the Natural Environment Protection Law and certain other acts (Dz.U. No. 113, item 954 of June 27th 2005) rendered the regulations governing the execution of projects which might affect Natura 2000 sites more stringent and enhanced the environmental protection-related requirements with regard to entering the areas of the occurrence of protected plant species and habitats of protected animals.

8. TRADE AND STORAGE

The principal activity of the segment is trade in natural gas. In Poland, where the PGNiG Group is the largest natural gas supplier, the segment sells natural gas produced from domestic fields or imported. Through PGNiG Sales and Trading GmbH (wholesale) and PST Europe Sales GmbH (retail sale), the PGNiG Group is also developing its natural gas business (both wholesale and sales to end users) in Germany and Austria.

The segment also trades in electricity, certificates of origin for electricity, and CO_2 emission allowances. The segment operates seven underground gas storage facilities (Brzeźnica, Husów, Mogilno, Strachocina, Swarzów, Wierzchowice and Kosakowo).

Companies of the Trade and Storage segment: PGNiG S.A., PGNiG Obrót Detaliczny Sp. z o.o., PGNiG Sales and Trading GmbH, PST Europe Sales GmbH, Operator Systemu Magazynowania Sp. z o.o.

8.1. Procurement of natural gas

In H1 2016, PGNiG S.A. purchased gas mainly under the following contracts:

- Contract with OOO Gazprom eksport for sale of natural gas to the Republic of Poland, dated September 25th 1996, effective until December 31st 2022;
- Agreement with VNG-Verbundnetz Gas AG for sale of Lasów natural gas, dated August 17th 2006, effective until October 1st 2016.

Since January 1st 2016, the natural gas purchased from VNG-Verbundnetz Gas AG has been sold in the German market, under an agreement executed with PGNiG Sales & Trading GmbH.

PGNiG Supply & Trading GmbH purchased natural gas on the German market, mainly in OTC transactions on the *NCG* (*NetConnectGermany*) and *Gaspool* virtual trading platforms. The company also purchased gas on the *European Energy Exchange* (*EEX*).

In H1 2016, to fulfil its trading obligations, the PGNiG Group purchased a total of 10,608 mcm of natural gas. The table below presents the structure of natural gas purchases measured as high-methane gas equivalent, by supplier.

Structure of natural gas purchases

	H1 2016		H1 2015	
	GWh	mcm	GWh	mcm
Foreign suppliers:	72,519	6,609	63,805	5,815
OOO Gazprom eksport	57,985	5,285	44,460	4,052
Other foreign suppliers	10,892	992	16,239	1,480
Exchange	3,642	332	3,106	283
Domestic suppliers:	43,873	3,999	47,161	4,299
Exchange	40,703	3,710	46,057	4,198
Other domestic suppliers	3,170	289	1,104	101
Total	116,392	10,608	110,966	10,114

In H1 2016, PGNiG S.A. continued its efforts to change the price terms of the 'Contract for gas supply to Poland' concluded on September 25th 1996 with OOO Gazprom eksport. The negotiations started on November 1st 2014. Having failed to achieve an understanding with the supplier (within the time frame provided for in the contract), PGNiG S.A. commenced the arbitration proceedings. The subject matter of the dispute is change of the price terms of the long-term gas supply contract. In the course of the arbitration proceedings, on February 1st 2016 PGNiG S.A. filed with the Arbitration Court a claim against PAO Gazprom and OOO Gazprom eksport. As at the date of preparation of this report, the proceedings before the Arbitration Court were pending.

New contracts

The first LNG supplies necessary in the cool-down and start-up of the LNG terminal in Świnoujście were delivered in December 2015 and February 2016. In January 2016, PGNiG S.A., Operator Gazociągów Przesyłowych GAZ-SYSTEM S.A. and Polskie LNG S.A. began testing the delivery of gas from the LNG terminal into the Polish transmission system. Under an agreement with Polskie LNG S.A. of December 28th 2015, PGNiG S.A. purchased gas from the start-up process and fed it into the transmission system. In addition, because of the need to test the LNG road tanker loading facility at the LNG terminal, on April 5th 2016 PGNiG S.A. and Polskie LNG S.A. executed an agreement under which PGNiG S.A. purchased from Polskie LNG S.A. 400 tonnes of LNG loaded into the tankers as part of the testing. Subsequently, PGNiG S.A. sold the gas to PGNiG Obrót Detaliczny Sp. z o.o. and a customer outside the PGNiG Group.

On June 17th 2016, the first commercial shipment of LNG under the long-term contract with Qatar Liquefied Gas Company Limited (3) was delivered to the Świnoujście terminal. Qatar Liquefied Gas Company Limited (3) supplied to PGNiG S.A. 206 thousand cubic metres of LNG, equivalent to 124 mcm of grid gas.

Additionally, PGNiG S.A. purchased on the spot market 136 thousand cubic metres of LNG, equivalent to 84 mcm of grid gas, from the Norwegian Statoil ASA. The LNG shipment arrived in Świnoujście on June 25th 2016.

8.2. Sales of natural gas

The main products sold by the Trade and Storage segment are high-methane gas and nitrogen-rich gas. Sale of natural gas at the Polish Power Exchange by PGNiG S.A. and purchase of natural gas at the Polish Power Exchange by PGNiG Obrót Detaliczny Sp. z o.o. are not eliminated on consolidation.

In H1 2016, the Trade and Storage segment sold 12,299 mcm, 11,088 mcm of which was sold on the domestic market. Compared with H1 2015, the volume of gas sold increased by approximately 1%. The table below presents sales of natural gas by the Trade and Storage segment (measured as high-methane gas equivalent).

Sales of natural gas

	H1 2016		H1 2015	
	GWh	mcm	GWh	mcm
High-methane gas	131,228	11,959	129,518	11,805
Nitrogen-rich gas	3,729	340	3,655	333
Total	**134,957**	**12,299**	**133,173**	**12,138**

In H1 2016, the PGNiG Group sold 5,521 mcm of natural gas on the Polish Power Exchange, which represented a 15% increase on the previous year. Sales through the exchange accounted for the largest portion of the Group's total gas sales. Gas was also sold directly to industrial customers (mainly in the chemical, oil refining and petrochemical sectors) and to households. The latter were the largest customer group (approximately 6.6m), accounting for97% of the entire PGNiG Group customer base. The table below presents the structure of sales of natural gas (measured as high-methane gas equivalent) by customer groups.

Gas sales by customer groups

	H1 2016		H1 2015	
	GWh	mcm	GWh	mcm
Industrial customers	32,317	2,945	39,737	3,622
Trade and services	14,495	1,321	13,267	1,209
Households	23,744	2,164	22,997	2,096
Wholesale customers	691	63	1,313	120
Utilities	2,955	269	2,876	262
Other customers	174	16	198	18
Exchange	60,581	5,521	52,785	4,811
Total	**134,957**	**12,299**	**133,173**	**12,138**

In H1 2016, the PGNiG Group sold 1,211 mcm of natural gas on foreign markets, primarily in Germany, mainly to households and small and medium-sized enterprises.

New contracts

On April 13th 2016, PGNiG S.A. concluded a framework agreement for sale of gas fuel and bilateral contracts with Grupa Azoty S.A. and its subsidiaries: Grupa Azoty Zakłady Azotowe Puławy S.A., Grupa Azoty Zakłady Chemiczne Police S.A., Grupa Azoty Zakłady Azotowe Kędzierzyn S.A., Grupa Azoty Kopalnie and Zakłady Chemiczne Siarki Siarkopol S.A. The framework agreement was concluded for an indefinite term, and it defines general terms of cooperation between the parties. The individual contracts were concluded for varying periods (with the longest contract expiring on September 30th 2019) and define commercial terms of gas supplies to each of the Grupa Azoty Group companies. The estimated aggregate value of the framework agreement and the individual contracts is approximately PLN 3.3bn, and the maximum volume of supplies over the entire term of the agreement is 4.5 bcm.

On June 22nd 2016, PGNiG S.A. signed contracts with EDF Gaz Toruń Sp. z o.o. and EDF Toruń S.A. for the supply of gas to EDF's new CHP plant in Toruń. The parties signed two contracts, one of which provides for the supply of gas for the plant's technical start-up and commissioning, executed by EDF Toruń S.A., and the other for the supply of gas after the plant comes on stream commercially, for the period from March 1st 2017 to October 1st 2019. The aggregate volume of contracted gas is approximately 355 mcm.

Promotional schemes offered by PGNiG S.A.

In H1 2016, PGNiG S.A. continued the '2015/2016 Price Deregulation' discount scheme launched on July 1st 2015. The scheme covers gas purchased from August 1st 2015 to the earlier of December 31st 2016 or the date when PGNiG S.A. is released by the President of URE from the obligation to submit gas tariffs for regulatory approval. Under the scheme, off-take contracts are settled on a quarterly basis, prices can be either fixed or indexed to an exchange-traded product selected by the customer, and customers can choose between flexible and base products. The scheme is available to PGNiG customers purchasing more than 25 mcm of natural gas per year. They come mainly from the chemical, petrochemical, glass, steel, and food-processing industries, but the group also includes wholesalers purchasing gas for resale. Participation in the scheme is voluntary and customers receive a discount on the tariff price. The scheme enjoys significant interest among PGNiG customers.

Promotional schemes offered by PGNiG Obrót Detaliczny Sp. z o.o.

In March and April 2016, PGNiG Obrót Detaliczny Sp. z o.o. launched a discount scheme 'Savings for you and your company W4' dedicated to the W-4 tariff group customers. The scheme was available to both existing and new gas fuel buyers. Under the scheme, customers were offered discount on the standard tariff price for the entire 2016. As the scheme turned out to be very popular among the W-4 tariff group customers, in June and July 2016, the Company launched the second edition of the scheme for the same tariff group. As during the first edition, the scheme is available to both existing and new customers. Under the scheme, customers are offered discount on the standard tariff price for the period of 12 months from July 1st 2016.

In the business customer segment (tariff groups above W–4), in 2016 PGNiG Obrót Detaliczny Sp. z o.o. continued discount schemes launched in 2015, but also launched new advanced products specifically designed for the largest customers.

In H1 2016, the company launched new editions of the 'Flexible Price' scheme for the largest accounts, i.e. customers in the W-6A, W-6B, W-8C and E tariff groups. The rules of the scheme were identical to those offered earlier and covered contracts concluded for 2016 and 2017.

Further, new editions of the 'Constant Savings for Business' scheme were launched for customers in the W-5 tariff group. The terms of the scheme were the same as those of the earlier editions.

In April 2016, the company launched an offering for customers demanding more advanced products, with gas prices linked to prices on energy exchanges. Customers may choose exchange indices by reference to which gas supply contracts will be settled. The idea is to combine the benefits of the 'Individual Pricing' and 'Indexed Offer' discount schemes. In May 2016, the 'Tranche Product' was launched, offered to customer demanding most advanced products. The product is linked exclusively to instruments listed on the Polish Power Exchange.

In June 2016, PGNiG Obrót Detaliczny Sp. z o.o.'s standard product offering was extended to include the 'Flexible Price' and 'Constant Savings for Business' schemes, based on fixed terms and pricing mechanisms. The terms of the schemes are updated on a regular basis (every week and every month, respectively), to reflect current exchange prices of gas and the number of customers who have responded to the offering.

8.3. Electricity

In H1 2016, PGNiG S.A. engaged in wholesale trading in electricity and related products in Poland and Germany. In Poland, the Company traded on the OTC market and on the Polish Power Exchange. In Germany, the Company was engaged in futures trading on the EEX (European Energy Exchange) market. PGNiG S.A. also provided services to PGNiG Obrót Detaliczny Sp. z o.o. and PGNiG TERMIKA S.A. under a commercial balancing agreement as the entity responsible for balancing, working directly with the power transmission system operator.

PGNiG Supply & Trading GmbH engaged in electricity trading in Germany on the EEX and OTC markets.

Sales of electricity

In H1 2016, on the domestic market the PGNiG Group sold electricity to business customers (tariff groups A, B and C), and to households (tariff group G). The Group sells electricity with price guarantees (for periods as long as until 2018) and offers full balancing of customers' electricity requirements.

The Group sold electricity to end users in Germany and Austria, where its customers included chiefly small and medium-sized companies, as well as households.

In H1 2016, the Company sold 4,073 GWh of electricity to customers in Poland, while exports amounted to 1,333 GWh. The table below presents sales of electricity, by customer group.

Sales of electricity (GWh)

	H1 2016	%	H1 2015	%
End user	128	2%	160	3%
Trading companies	1,097	20%	412	9%
Balancing market	183	4%	155	3%
Exchange	3,998	74%	4,062	85%
Total	**5,406**	**100%**	**4,789**	**100%**

8.4. Storage

The Trade and Storage segment uses for its own needs the working capacities of the Wierzchowice, Husów, Strachocina, Swarzów and Brzeźnica underground gas storage facilities, as well as the Mogilno and Kosakowo underground cavern facilities. A part of the working capacity of the Mogilno facility, which was made available to OGP GAZ-SYSTEM S.A., is not a storage facility within the meaning of the Polish Energy Law.

Short-term peak fluctuations in demand for natural gas may be balanced by the supplies from the Mogilno and Kosakowo facilities, where gas is stored in worked-out caverns. The capacities of the Wierzchowice, Husów, Strachocina, Swarzów and Brzeźnica facilities are used to minimise the effect of changes in demand for natural gas in the summer and winter seasons, to meet the obligations under the take-or-pay import contracts, to ensure the continuity and security of natural gas supplies, and to meet the obligations under contracts for gas deliveries to customers' premises.

The capacities of the Mogilno, Kosakowo, Wierzchowice, Husów and Strachocina storage facilities are also used by PGNiG S.A. to meet its obligation to maintain mandatory stocks, imposed by the Act on Stocks of Crude Oil, Petroleum Products and Natural Gas, as well as on the Rules to be Followed in the Event of Threat to National Fuel Security or Disruptions on the Petroleum Market, dated February 16th 2007. In the period from October 1st 2015 to September 30th 2016, PGNiG S.A. is required to maintain mandatory stocks of 8,919 GWh, or approximately 815 mcm.

PGNiG S.A.'s storage capacities are managed by Operator Systemu Magazynowania Sp. z o.o.

Tariff

Until May 31st 2016, Operator Systemu Magazynowania Sp. z o.o. charged fees for its storage services at the rates provided for in Gas Fuel Storage Tariff No. 1/2015 of May 25th 2015. On April 22nd 2016, the President of URE approved Gas Fuel Storage Tariff No. 1/2016 for the period until March 31st 2017. The new tariff took effect on June 1st 2016. Concurrently, the amended Rules for Provision of Storage Services came into force. They reflect the addition of new storage capacities of the extended Mogilno and Kosakowo gas storage facilities.

Licence

By a decision of March 21st 2016, the President of URE extended the scope of Operator Systemu Magazynowania Sp. z o.o.'s licence to store gas fuels in storage facilities to reflect the increased working capacities of the Kosakowo (addition of 119 mcm) and Mogilno (addition of 594.7 mcm) facilities.

The provision of storage services based on the new capacities of the Kosakowo and Mogilno facilities commenced on June 1st 2016, that is on the effective date of Gas Fuel Storage Tariff No. 1/2016.

Third-party access (TPA) storage capacities

As at June 30th 2016, the PGNiG Group had a total working storage capacity of 2,928.7 mcm, of which 2,888.5 mcm was available to OGP GAZ-SYSTEM S.A. under a long-term contract on a TPA basis. Under a short-term contract expiring at the end of the Gas Day on May 31st 2016, the PGNiG Group held 31.5 mcm of TPA storage capacity. In H2 2016, after the temperature of the gas held in storage stabilises, up to 35 mcm of TPA working storage capacity will become available under short-term contract. 5.2 mcm of Kawerna's working capacity is allocated for the Mogilno and Kosakowo cavern facilities' own needs. The table below presents total working capacities and TPA working capacities as at June 30th 2016 and June 30th 2015.

Total working capacities and TPA working capacities

	Working storage capacities (mcm)		TPA working storage capacities (mcm)		TPA working storage capacities (GWh)[1)]	
	H1 2016	H1 2015	H1 2016	H1 2015	H1 2016	H1 2015
Kawerna SFG*	713.7	520.3	673.5	437.0	7,390	4,795
Wierzchowice underground gas storage facility	1,200.0	1,200.0	1,200.0	1,200.0	13,166	13,166
Sanok SFG**	1,015.0	1,015.0	1,015.0	865.0	11,137	9,491
Total	**2,928.7**	**2,735.3**	**2,888.5**	**2,502.0**	**31,693**	**27,452**

[1)]Converted to gas with calorific value of 39.5 MJ/cm
* Kawerna SFG – Storage Facility Group comprising the Kosakowo UGSC and Mogilno UGSC.
** Sanok SFG – Storage Facility Group comprising the Husów UGS, Strachocina UGS, Brzeźnica UGS and Swarzów UGS.

As at the end of H1 2016, 98% of storage capacities were reserved for PGNiG S.A., with the remaining 2% reserved for third-party customers, including OGP GAZ-SYSTEM S.A.

8.5. Planned activities

Storage

In 2016, PGNiG S.A. will continue to extend the working storage capacity of the Brzeźnica UGS from 65 mcm to 100 mcm and construct the high-methane Kosakowo UGSC with a storage capacity of 250 mcm.

Procurement of natural gas

In H2 2016, PGNiG S.A. will continue to purchase imported gas under the long-term contract with OOO Gazprom eksport, and from Qatar Liquefied Gas Company Limited. If an unpredicted surge of demand for gas fuel occurs, the Company will purchase natural gas under short-term contracts from the neighbouring countries or on the LNG market, wherever more favourable prices will be asked.

Sales of natural gas

In H2 2016, the PGNiG Group intends to further enhance its product offering and improve customer satisfaction by focusing on continuous improvement and streamlining of customer service, and by building new and developing the existing customer access channels. Further, in the face of growing competition, the Group plans to intensify initiatives designed to maintain sales volumes by offering special discount schemes to customers.

8.6. Risks related to trade and storage

Deregulation of natural gas prices

The pending deregulation of the Polish gas market and changes in the legal framework have led to major changes on the market. In 2012, a natural gas market was launched on the Polish Power Exchange. Under a decision of the President of URE, gas trading on the exchange has been excluded from the tariff regime. Prices of gas paid by end users are also expected to be gradually liberalised as the process of deregulation advances. with wholesalers and largest industrial accounts being the first customer group to enjoy the benefits of liberalised gas prices.

As regards gas trading on the Polish Power Exchange or direct sales to customers at prices similar to those quoted on the exchange, there is a risk that revenues from such sales will be lower than gas procurement costs due to the growing disconnect between the market prices of gas and of petroleum products, to which gas prices in the long-term import contracts continue to be linked.

On the other hand, lifting the price caps in contracts with customers will mitigate the risk that the PGNiG Group would have to sell gas at capped prices where actual market prices were higher than the tariff. Consequently, symmetry will be restored in contracts with customers, i.e. the price risk will be evenly distributed between customers and the PGNiG Group. At present, due to the price caps, the risk is not evenly distributed, with suppliers (PGNiG Group companies) bearing much larger risks than their customers do.

Competition

In H1 2016, some of PGNiG S.A.'s customers purchased gas from alternative suppliers. Increased interest in purchasing gas directly at border entry points could be seen among the largest industrial customers, as this procedure does not require them to obtain energy efficiency certificates and surrender them for redemption, or to pay a buy-out price. If this trend continues in the coming years, it will increase the risk that volumes of gas sold by PGNiG S.A. may shrink. To mitigate this risk, PGNiG S.A. continued the 'Price Deregulation' discount scheme launched in 2015.

This risk also applies to PGNiG Obrót Detaliczny Sp. z o.o. Competitors seek to increase sales of gas by offering competitive prices of the fuel or by offering gas and electric bundles. According to the Energy Regulatory Office data, more than 23 thousand customers switched their gas suppliers in 2015. The number is expected to grow in the coming years, particularly in the context of the churn rates on the gas market in 2014 and 2015, as reported by the Energy Regulatory Office.

The activity of the competitors, as well as the growing customer awareness, result in growing market pressure on PGNiG Obrót Detaliczny Sp. z o.o. to reduce gas prices and set contract terms on a case-by-case basis. By offering attractive discount schemes to its customers, the Company is now able to defend its market position more effectively, often regaining lost volumes in the group of large business customers.

PGNiG Obrót Detaliczny Sp. z o.o. is consistently perceived as a reliable and secure supplier. To maintain its competitive position and ability to offer attractive prices to customers, the company continues its efforts to optimise costs and reorganise internal processes, and rolls out new products and services. In H1 2016, PGNiG Obrót Detaliczny Sp. z o.o. reduced its retail gas prices on two occasions. In total, the average gas price was reduced by 8.6% (high-methane gas). From a market perspective, the price reductions improved the company's competitive position.

The legislator has taken steps to secure level playing field for competitors on the Polish gas market. The initiatives aim at removing regulatory loopholes which made it possible to evade domestic regulations. The amendments imposed the obligations defined in the Energy Efficiency Act on end users connected to the grid in Poland and importing gas for their own needs; further, all importers of gas and all trading companies which import gas were included in the list of entities obligated to hold mandatory stocks of the fuel (liquidation of 'exemptions'). The legislator believes that these changes in the legal framework will improve competition on the Polish gas market. An additional benefit of the amendments is the strengthening of Poland's energy security.

Take-or-pay gas supply contracts

PGNiG S.A. is a party to three long-term take-or-pay contracts for gas supply to Poland. The most important of these are the contracts with OOO Gazprom Eksport and Qatar Liquefied Gas Company Limited (3). Assuming that PGNiG S.A.'s customer portfolio remains unchanged, the volume of gas imports specified in the take-or-pay contracts will limit its purchases of spot gas, which are currently most attractive in price terms. In PGNiG S.A. loses its market share, there is a risk that the Company would be forced to look for new ways to utilise the surplus volumes of gas in its portfolio. Otherwise, the Company will have to pay for the gas it has not collected (under the *take or pay* clauses).

A supplementary agreement to the contract for sale of liquefied natural gas (LNG), executed by PGNiG S.A. and Qatar Liquefied Gas Company Limited (3) in 2015, eliminated the risk of PGNiG S.A. having to pay for uncollected LNG in H1 2016 under the take-or-pay clause.

Disruptions to gas supplies from countries east of Poland

Given the continuing political instability in Ukraine, there is a risk of limitation in gas supply from the east, under the Yamal contract. On June 30th and July 1st 2016, at the Drozdovitse entry point on the Polish-Ukrainian border, the recorded pressure of the gas supplied was below the level stipulated in the contract, i.e. the volume of gas supplied to PGNiG S.A. was lower than ordered. There was no threat to the Company's ability to supply gas to its customers owing to the Company's diversified sources of supply.

Obligation to diversify gas imports

The Council of Ministers' Regulation of October 24th 2000 on the minimum level of diversification of foreign sources of gas supplies prescribes the maximum share of gas imported from a single country in total gas imports in a given year. In 2015–2018, the share may not exceed 59%. PGNiG S.A. is a party to a long-term take-or-pay contract with OOO Gazprom eksport of September 25th 1996. However, the Regulation does not take into account the specific position of PGNiG S.A. in the context of its obligations under the contract. In 2015, the Ministry of Economy recognised the need to amend the Regulation and began work on a new draft.

In previous years, the President of URE instigated administrative proceedings to impose a fine on PGNiG S.A. for its failure to comply with the diversification requirement in 2007−2013.

As long as the Regulation is not amended, the President of URE will be able to impose fines on the Company for failing to comply with the diversification requirement until gas starts to be supplied from other sources (e.g. through the LNG terminal). For failing to comply with the obligation in 2007−2008, the President of URE imposed on the Company a fine of PLN 2m. The Polish Court of Competition and Consumer Protection reduced the fine to PLN 1.5m, and subsequently, the Court of Appeal in Warsaw reduced it further to PLN 0.5m. On January 30th 2015, the Company paid the fine. In May 2015, PGNiG S.A. filed a cassation appeal against the ruling of the Court of Appeals in Warsaw. On April 21st 2016, the Supreme Court reversed the decisions of the Court of Appeal and of the Competition and Consumer Protection Court at the Regional Court of Warsaw, and also changed the decision of the President of URE. Pursuant to the Supreme Court's ruling, PGNiG S.A. did not breach the terms of its licence, as charged by the President. Accordingly, PGNiG S.A. will move to the President of URE for reimbursement of the paid amount of PLN 0.5m, plus accrued interest. The Supreme Court's ruling was the final and conclusive stage of the proceedings.

On December 30th and 31st 2015, the President of URE imposed on PGNiG S.A. financial penalties of PLN 2m and PLN 4m, respectively, for breaching the terms and conditions of the licence granted to the Company for international trade in gas, by failing to comply with the obligation to diversify supplies of imported gas in 2009 and 2010. On January 21st 2016 and January 22nd 2016, PGNiG S.A. appealed against the decisions to the Competition and Consumer Protection Court at the Regional Court of Warsaw. As at the date of this Report, the proceedings were pending.

9. DISTRIBUTION

The segment's principal business activity consists in the transmission of high-methane and nitrogen-rich gas, as well as of small amounts of propane-butane and coke-oven gas over the distribution network. Also, the segment is engaged in extending and upgrading the gas network and connecting new customers to the existing network and to new sections of the network.

Gas distribution services are rendered by Polska Spółka Gazownictwa Sp. z o.o. (PSG). As the Distribution System Operator, the company conducts its business in all provinces of Poland. The company enjoys a dominant share in the market and supplies gas to customers all over the country. PSG owns approximately 96% of Poland's distribution network and nearly 99% of the gas service lines.

9.1. Segment's activities

In H1 2016, all settlements between PSG and its customers were based on amended Tariff No. 3 for Gas Fuel Distribution Services and LNG Regasification Services, as approved by the President of URE on December 16th 2015.

On June 9th 2016, the President of URE approved the second amendment to Tariff No. 3 for Gas Fuel Distribution Services and LNG Regasification Services, and extended its term until December 31st 2016. Rates of distribution and regasification service charges remain unchanged.

In H1 2016, the Distribution Grid Code for PSG, approved by the President of URE on February 16th 2015, was in effect. In the reporting period, PSG submitted draft new Distribution Grid Code to the President of URE for approval. As at the date of this Report, the proceedings were pending.

On May 11th 2016, the President of URE designated PSG as the entity responsible for forecasting network user's non daily metered off-takes, in accordance with Art. 39(5) of the Balancing Network Code (BAL NC, the Commission Regulation (EU) No. 312/2014 of 26 March 2014 establishing a Network Code on Gas Balancing of Transmission Networks). In accordance with Art. 42(2) of BAL NC, PSG is obligated to develop and obtain approval for a methodology of forecasting network user's non daily metered off-takes for users connected to the PSG distribution network. In the performance of this obligation, PSG developed the 'Method of forecasting network user's non daily metered off-takes', which will be presented to market participants for consultation.

PSG's key investment projects in H1 2016:

- Redevelopment of a 61 km high-pressure gas pipeline from Sandomierz to Ostrowiec Świętokrzyski; in H1 2016, the design work was continued and construction and assembly work was conducted on a section of approximately 3 km;
- Continued work on the upgrade of the Łódź Ring, including the upgrade of the high-pressure gas pipeline from Konstantyna to Meszcze. The project involves a series of tasks designed to improve the technical condition of the gas network, and also provides for redevelopment of ca. 52 km of gas pipelines, overhaul and upgrading work on gas stations on the gas pipelines of the Łódź Ring and the construction of high-pressure regulating stations; execution of the individual stages of the project is scheduled until 2020; in H1 2016, the construction work was completed on the Łódź–Smulsko high-pressure gas station along with high- and medium-pressure gas pipelines; work on the construction of the block/bleed/connection system on the high-pressure gas pipeline from Rzgów to the Pabianice block system in Ksawerów continued; work on the construction and conversion of high-pressure gas stations in Niewiadów continued; design work on the construction and conversion of the block/bleed system at the pressure reduction and measurement station in Szynkielew was completed; design work on further stages of the project continued;
- Continued design work on the upgrade of a 37 km high-pressure gas pipeline from Parszów to Kielce. Development of project design documentation is planned to be completed by the end of 2016; the completion of the project was delayed due to difficulties in obtaining legal titles to properties for construction purposes;
- Continued design work on the upgrade of a 21 km section of the high-pressure gas pipeline from Lubienia to Parszów;

- Upgrade of the high-pressure gas pipeline from Warzyce to Gorlice; in 2016, construction and assembly work was continued; approximately 150 m of the pipeline remains to be constructed;
- Extension of high-pressure stations and gas mains fed from the Warsaw Ring. The project is designed to improve the transmission capacity and security of gas supplies within the city of Warsaw; the project involves construction of the Sękocin high-pressure station (completed in 2014), Jabłonna high-pressure station, Sokołów high-pressure station, Ząbki high-pressure station and a medium-pressure gas pipeline with a total length of ca. 11 km; in H1 2016, design work for the Ząbki high-pressure station continued; contractors for the Jabłonna and Sokołów stations were selected;
- Extension of high- and medium-pressure gas network in Września; the project involves construction of three medium-pressure gas stations, medium-pressure gas pipelines with a total length of 31.5 km, a high-pressure gas station, and a high-pressure gas pipeline with a length of 10.2 km; given the differentiated complexity and multifaceted nature of work, project implementation has been divided into the following three stages:
  - ✓ Stage 1: high pressure reduction and measurement station in Września − construction work in progress; a 2.5 km medium-pressure gas pipeline – completed; connections and stations in Białężyce – completed;
  - ✓ Stage 2: a 24km medium-pressure gas pipeline from Środa Wielkopolska to Białężyce – design work in progress; a 5 km medium-pressure gas pipeline from Września to Białężyce – construction work in progress;
  - ✓ Stage 3: a 10.2 km high-pressure gas pipeline from Nekla to Września – design work in progress;
- Modernisation of the gas network in Stara Wieś and Kozietuły in the Belsk Duży commune. The project involves construction of a 11.4 km gas pipeline and a medium-pressure gas pipeline with a length of 1.4 km. In H1 2016, construction work under the project was completed;
- Construction of a high-pressure station with auxiliary infrastructure in Zagrodno;
- Construction of a pressure reduction and measurement station in Oława – as part of a project to remove transmission obstacles;
- Construction of a pressure reduction station with a boiler room and odorising unit, and a block/bleed system in Nowy Kisielin – designed to improve the transmission capacity and security of gas supplies to Zielona Góra.

PSG also connected new customers to the gas grid. Key projects in this area included:

- Distribution network roll-out in Przasnysz and Chorzele. The project involves construction of a high-pressure reduction and measurement station, two increased medium-pressure reduction and measurement stations, a 65 km increased medium-pressure pipeline and a 7 km medium-pressure pipeline; in H1 2016 design work on the Lekowo-Przasnysz gas pipeline and medium-pressure networks in Przasnysz and Chorzele was continued; construction work commenced on a 30 km increased medium-pressure Przasnysz-Chorzele pipeline; construction of the Lekowo high-pressure station and construction of increased medium-pressure reduction and metering stations in Sierakowo and Brzesko Kołaki was completed (the connection work under the connection agreement with OGP GAZ-SYSTEM S.A. remains to be executed);
- Distribution network roll-out in Bielsk Podlaski. The project involves connecting Miejskie Przedsiębiorstwo Energetyki Cieplnej S.A. of Bielsk Podlaski to the gas network; the customer has declared to accept 15 mcm of gas fuel p.a. (following modernisation of the town's central boiler house); in H1 2016, tender proceedings were conducted to award contract for design documentation update;
- Connecting the Bydgoszcz power utility to the gas network. The project involves the construction of an 8 km high-pressure gas pipeline and a high-pressure metering station; design work was continued in H1 2016.
- Distribution network roll-out in the Kłobuck, Wręczyca Wielka, Opatów and Krzepice municipalities/communes; the project involves extension of a gas network with a length of ca. 109 km (90 km of medium-pressure sections and ca. 20 km of high-pressure sections); in H1 2016, design work was under way.

In H1 2016, PSG accounted for 18 projects (completed in 2015) executed under the Infrastructure and Environment Operational Programme for 2007–2013. The aggregate value of the projects was PLN 498m, including PLN 169m of EU funds.

PSG also prepared application documentation and, on June 30th 2016, submitted applications for EU co-financing for ten investment projects under the Infrastructure and Environment Operational Programme for 2014−2020.

In the reporting period, PSG also conducted analytical work focused on development of the distribution system and development of gas transmission using the LNG technology.

The tables below present the segment's key operating data.

	H1 2016		H1 2015	
Distribution services	GWh	mcm*	GWh	mcm*
- high-methane gas	54,997	4,887	52,121	4,669
- nitrogen-rich gas	3,145	287	3,100	283
- propane-butane-air and decompressed propane-butane	0	0	1	0
- coal gas	1,506	137	1,327	121
Volume of gas supplied to customers	**59,648**	**5,311**	**56,549**	**5,073**

*mcm measured as high-methane gas equivalent

	Unit of measure	H1 2016	H1 2015
Length of network, excl. connections*	km	128,553.9	126,006.7
No. of customers**	('000)	6,876.3	6,840.2
No. of new customers connected to the network***	('000)	39.1	35.8

*Own and third-party networks.
**Points of exit from the distribution system.
***Orders to commence supplies after a general gas supply contract has been concluded.

9.2. Planned activities

In H2 2016, PSG will continue to pursue projects consisting in construction and extension of gas networks and connection of new customers. The company also intends to establish cooperation with energy utilities to use the business opportunities created by application of the Power to Gas (P2G) technology in power generation. The process involves conversion of surplus electricity into hydrogen (H_2) and, following methanation, into synthetic natural gas (SNG). Indirect (low-emission) energy carriers may be stored in the gas grid, which has large storage capacities and high flexibility, and then be used in accordance with the business needs of customers, e.g. to generate power in fuel cells or high-efficiency gas turbines. The gas grid will become a sub-system of the future integrated and convergent Smart Power Grid.

In the coming years, the company intends to implement an investment model that would promote growth in the volume of transferred gas and accelerate its key investment projects. In order to carry out its plans, PSG intends to rely on external funding available under EU programmes planned as part of the new multiannual financial framework 2014–2020. Particular emphasis will be placed on intensifying acquisition of new customers and improving the reliability of gas networks and security of gas supplies.

PSG is also planning to develop its research, development and innovation activities (R+D+I). These activities will focus on research into ways of improving the reliability, ensuring safety and raising efficiency of the gas infrastructure, and will be conducted mainly through demonstration projects (promoted in the current multiannual financial framework 2014–2020), but also based on any other model allowing the company to tap into external funds. Such approach will enable the company to optimally utilise the EU funding and take advantage of certain tax incentives available under the Act Amending Certain Acts to Support Innovation, which has been in effect since January 1st 2016.

The company is also monitoring the market for opportunities to commercialise new innovative technologies and create innovative services that would enable it to evolve its core business and thus expand into new markets or increase market share. PSG is looking into ways to expand the functionality of its gas infrastructure to make it capable of transporting natural gas with an admixture of other gases, including biogas, synthetic natural gas (SNG), CO_2 and hydrogen. The analysis focuses on both technological and regulatory aspects of the problem. An upgrade of the gas networks to so expand their functionality would allow the company to launch new services and connect new customers from the power sector (stabilisation of the power system, fuel supply to portable and local electrical appliances powered by fuel cells), as well as the automotive sector and other industries where hydrogen is used in production processes. These efforts may translate into higher volumes of transferred gas and thus may increase PSG's future revenues.

The company also intends to consistently leverage the opportunities opening up in its business, regulatory and social environment with regard to:

- introduction of new regulations supporting the development of cogeneration and commercial power plants,
- changes in the regulatory framework that would facilitate implementation of the company's key investment projects,
- growing demand for natural gas from large and medium-sized customers (heat plants and CHP plants, manufacturing and industrial plants, service centres),
- reduction, in the medium term, of gas fuel prices due to liberalisation of the gas market and situation in the global markets, stimulating increase in demand for gas and, as a consequence, for distribution services,
- ways to shape the gas market (e.g. through participation in regulatory consultations with the Energy Regulatory Office and the Ministry of Energy),
- obtaining EU co-financing for the company's key investment projects and deployment of innovative technologies,
- further network roll-out and connection of customers in regions with poor gas supply infrastructure (e.g. central and north-eastern regions Poland), also based on the LNG technology.

In H2 2016, PSG will also focus on implementing a new organisational structure, moving from a four-tier to a three-tier management system, i.e.:

- the Head Office,
- gas distribution companies (branches),
- local gas utilities.

Upon the restructuring, PSG will comprise the Head Office, 17 gas distribution companies (branches), and 231 local gas utilities and service points. The gas distribution companies will be located in Szczecin, Koszalin, Gdańsk, Olsztyn, Białystok, Bydgoszcz, Warszawa, Łódź, Poznań, Gorzów Wielkopolski, Wrocław, Opole, Kielce, Lublin, Kraków, Zabrze and Jasło.

Streamlining of the PSG organisational structure will enhance management efficiency, provide customers with easier access to services, and improve profitability of the business.

The company will also work on implementing its new strategy for 2016-2022, with the following four sets of objectives:

- finance – objectives: higher profitability, maintaining manageable costs, increasing gas distribution volumes,
- customers – objectives: gas network roll-out, acquiring new customers, enhancing customer satisfaction,
- processes – objectives: improved security and continuity of gas supplies, shorter connection procedure, shorter investment process, improved customer service,
- resources – objectives: ensuring continuity of skills and competencies, fostering employee motivation, implementing a uniform management system, developing an innovation management system.

The objectives will be achieved through gradual implementation and consistent pursuit of specific goals, supported by defined initiatives, projects and processes, as well as a set of strategic and operational tasks, including implementation of a central HR system, development of the ultimate IT architecture at PSG, including the centralised support system and the GIS, ERP and CIS tools.

9.3 Risks related to distribution

Legislation

The provisions of the Construction Law and regulations governing construction projects impose the obligation to prepare extensive project and legal documentation, which is an integral part of any development process. The need to prepare such documentation protracts the time needed for project preparation and thus may significantly delay its completion, exposing the company to the risk of cost overruns caused by potential delays in contract performance, as well as to the risk of revenues. The PGNiG Group has assumed a multifaceted approach to mitigating the risk:

- it optimises the process of project preparation and implementation to minimise the time necessary to secure the necessary permits and arrangements,
- it proposes legislative changes,
- it actively cooperates with stakeholders, both utilities and local governments, to expand the distribution system.

Tariff policy

Poland has no long-term tariff policy for natural gas distribution operators that would outline detailed rules and methodologies for determining the level of regulatory revenue acceptable to the regulator. The prevailing practice is to determine short-term tariffs based on annual negotiations with the President of URE. This solution gives the President of URE much room for discretion in the process of evaluating costs incurred by the Distribution System Operator, its investment expenditure and regulatory value of its assets. This is a source of uncertainty as to the amount of revenue and profit that may be generated by the company. In order to mitigate this risk, in 2015 PSG approached the President of URE with its proposal of a "Long-Term Strategy with respect to Regulation and Tariffs at PSG for 2016−2018". In August 2016, in cooperation with the Energy Regulatory Office, the company intends to start work on a long-term model for setting tariffs for three- to five-year periods.

Falling gas consumption

A decline in the average gas consumption by small customers is attributable to the improving energy efficiency of buildings (thermal modernisation) and reduced usage of individual gas-fired boilers for heating water. Thermal modernisation of buildings includes thermal insulation of outer walls, replacement of windows, use of condensing boilers, automated control of heating systems, and installation of solar panels. Even though PSG acquires more than 80 thousand new customers per year (mostly retail customers), the total volumes of gas supplied in this segment have been decreasing, causing the company to lose some of its revenue from distribution services.

Large customers opting for reconnection from distribution network to transmission network

In view of the growing competition in the sector, there is a risk that the company's large customers may opt for reconnecting directly to the gas transmission network operated by OGP GAZ-SYSTEM S.A. Customers justify their willingness to reconnect by pointing to the need to cut costs. The departure of some customers would mean a loss of transferred gas volumes and thus also of revenue from sale of distribution services and, as a consequence, would cause the need to cover any resulting excess of costs over revenue, for instance by increasing tariff rates. In order to mitigate this risk, the PGNiG Group supports introduction of legislative changes that would clarify the rules for reconnection of customers from the distribution network to the transmission network and for connection of new customers.

Claims raised by property owners

More and more frequently, PSG is facing excessive financial claims raised by the owners of land where the gas network was developed in the past. Transmission easement serves as a basis for determining the extent of the use of third-party property by a transmission company, for which fair consideration is due to the owner. Furthermore, land owners raise compensation claims for extra-contractual use of land by the company. The owners' claims give rise to additional, frequently considerable costs, and thus may adversely affect the financial performance of the segment.

Sources of gas supply for the distribution system

PSG's distribution network is connected to the transmission system operated by OGP GAZ-SYSTEM S.A., which is its main source of gas supplies. The transmission system's limited capacity in terms of the volume and pressure of supplied gas hinders or sometimes renders impossible further development of the gas grid within the company's key areas of operation. In order to remove these limitations, the PGNiG Group works closely with OGP GAZ-SYSTEM S.A. to set common development directions and reviews investment projects on a regular basis, thus ensuring efficient and optimum growth of the transmission and distribution infrastructure.

Substitution

Continuing low prices of coal, hydrocarbons (fuel oils, heating oils) and other energy carriers used for municipal heating are hardly an incentive (in particular for retail customers) to switch to environmentally friendly gas fuel. In this context, support to the company's plans to increase its revenue from sale of distribution services comes from local authorities, which implement various programmes aimed at reducing low emission sources and offering financial support to those willing to change their heating system. Among institutional customers, decisions to change the fuel used for heating purposes are made based on a cost-to-benefit analysis, taking into consideration a possible reduction of staff costs, equipment operating costs and flue gas emission charges.

Direct competition

Liberalisation of the gas market is contributing to intensified competition in the segment. Companies distributing natural gas are progressively expanding their gas networks and attracting new customers. Additionally, companies have emerged which offer LNG distribution services. The market entry barriers are significantly lower here, as LNG distribution involves much lower capital expenditure and does not require a connection to the gas system or adequate reserve capacity to be maintained in the transmission and distribution networks. Another issue which affects the segment's competitive position is the tariff policy of the Energy Regulatory Office, which makes it difficult for the PGNiG Group to operate a flexible pricing policy for some groups of customers. With the lack of flexible pricing, competitors' offers may prove to be an attractive alternative to the PGNiG Group's customers. The activities of companies competing on local markets will not have a significant effect on the position of PSG, therefore the risk of the company losing its dominant market position is low. However, the company constantly monitors the business decisions of its key competitors.

10. GENERATION

PGNiG TERMIKA S.A. is the Group's competence centre for heat and electricity generation as well as execution of heat and power projects.

The company's main revenue sources are sales of heat, electricity, system services, and certificates of energy origin. The installed capacity of the company's generating assets is 4.8 GW of achieved thermal power and 1 GW of achieved electrical power, which satisfies approximately 70% of the heat demand on the Warsaw metropolitan market.

In April 2016, Przedsiębiorstwo Energetyki Cieplnej S.A. of Jastrzębie Zdrój (PEC Jastrzębie S.A.) was added to the Generation segment.

10.1. Segment's activities

The segment's principal business activity is the generation of heat and electricity. In H1 2016, the generation segment comprised PGNiG TERMIKA S.A. and Przedsiębiorstwo Energetyki Cieplnej S.A. of Jastrzębie Zdrój (PEC Jastrzębie S.A.).

On April 28th 2016, PGNiG TERMIKA S.A. finalised the purchase of 100% of shares in PEC Jastrzębie S.A. from Spółka Energetyczna Jastrzębie S.A. for PLN 190.4m.

PEC Jastrzębie is involved in the generation, distribution and sale of heat and electricity in the municipalities of Jastrzębie-Zdrój, Pawłowice, Knurów, Czerwionka-Leszczyny, Racibórz, Kuźnia Raciborska, Rybnik, Wodzisław-Śląski and Żory. The company operates 288 km of heating networks and 14 local heating plants, which generate 40% of all heat sold by PEC. The total volume of heat sold by the company in 2015 was 2.6 PJ. The total installed capacity of PEC Jastrzębie S.A. is 257.05 MWt.

Licences

As at June 30th 2016, PGNiG TERMIKA S.A. held an electricity trading licence valid until December 31st 2030, as well as the following licences, each valid until December 31st 2025:

- licence to produce heat,
- licence to distribute and supply heat,
- licence to produce electricity.

As at June 30th 2016, PEC Jastrzębie S.A. held licences to produce, distribute, supply of and trade in heat, each valid until June 30th 2024.

Tariffs

In H1 2016, a tariff approved by the President of URE (on July 29th 2015) was applicable to PGNiG TERMIKA S.A.'s sales of heat generated at the Żerań CHP, Siekierki CHP, Pruszków CHP, Wola Heating Plant and Kawęczyn Heating Plant, and to the transmission and distribution of the heat through the heating network, supplied from the Pruszków CHP plant; and a tariff approved by the President of URE (on May 13th 2015) was applicable to the production of heat at the Regaty heating plant and transmission of the heat through the heating network in the Regaty residential estate.

Also in H1 2016, tariffs approved by the President of URE on November 18th 2015 applied to transmission of heat by PGNiG TERMIKA S.A. in the areas of Marsa Park, Annopol, Marynarska, Chełmżyńska and Jana Kazimierza, which were approved by the President of URE on November 18th 2014.

In H1 2016, PEC Jastrzębie S.A. applied "Heat Tariff 15" approved by the President of URE on June 10th 2015. On July 12th 2016, PEC Jastrzębie S.A. submitted a motion to the Energy Regulatory Office in Katowice for approval of new "Heat Tariff 16". As at the date of this H1 2016 report, the proceedings were pending.

Production

PGNiG TERMIKA S.A.'s main products are heat and electricity. In H1 2016, 100% of electricity produced by PGNiG TERMIKA S.A. was cogenerated with heat. The table below presents PGNiG TERMIKA S.A.'s production volumes.

Electricity and heat production volumes

	Unit of measure	H1 2016	H1 2015
Electricity	GWh	2,329	2,311
Heat	TJ	21,633	21,040

In H1 2016, PEC Jastrzębie S.A. produced 735 TJ of heat.

On February 2016, PGNiG TERMIKA S.A. executed with PSE Operator S.A. an agreement for provision of Network Constrained Generation services, pursuant to which the company maintains a long-term plant margin and keeps a specific number of generating units available, so as to overcome limitations in the operation of power sources in the national power system and to ensure Warsaw's energy security. PGNiG TERMIKA S.A. is required to generate electricity whenever so instructed by the Transmission System Operator. In performance of the agreement, by June 30th 2016 the company had generated 54.7 GWh of electricity.

Sales

In H1 2016, PGNiG TERMIKA S.A. sold 21,461 TJ of heat. The company sold heat mainly to Veolia Energia Warszawa S.A. (formerly Dalkia Warszawa S.A.), which purchased 93% of the heat produced by the company. In the first half of 2016, Veolia Energia Warszawa S.A. contracted 3.4 GW of PGNiG TERMIKA's heat generation capacity. The balance of the heat output was sold directly to end customers in Warsaw and Pruszków, and to customers connected to the Regaty Heating Plant's network.

The volume of heat produced by PEC Jastrzębie S.A. was 641 TJ, and the volume of heat traded by the company was 952 TJ.

In H1 2016, PGNiG TERMIKA S.A. sold a total of 1,980 GWh of electricity generated by its plants; this included 49 GWh of electricity sold under the Network Constrained Generation services agreement. The key customer for electricity generated at PGNiG TERMIKA S.A.'s plants was PGNiG S.A., with a 99% share in the volume of electricity sold by the company in H1 2016. The company also sold electricity to smaller customers, whose installations are connected directly to PGNiG TERMIKA's systems.

In H1 2016, PGNiG TERMIKA S.A.'s electricity portfolio was managed by PGNiG S.A., which trades in electricity on the forward and spot markets. PGNiG S.A. also handled commercial balancing for PGNiG TERMIKA S.A.

In 2015, the company sold property rights attached to certificates of origin for electricity produced by cogeneration (red certificates) on spot and forward markets of the Polish Power Exchange. The company sold the certificates of origin to PKP Energetyka S.A., PGE S.A. and ENEA Trading. 2,607 GWh worth of property rights were sold, with a further 1, 500 GWh of 2016 property rights contracted by PGE S.A.

The company contracted approximately 1,1480 thousand tonnes of EUAs to June 30th 2016 to cover the costs of deficit in CO_2 emission allowances.

Construction of CCGT unit in Stalowa Wola

In H1 2016, no construction work was performed as part of the Stalowa Wola CCGT project (a joint project with Tauron Polska Energia S.A.).

Due to Abener Energia S.A.'s failure to comply with the schedule and material technical conditions of the contract, Elektrociepłownia Stalowa Wola S.A. terminated the contract on January 29th 2016.

Abener Energia S.A. deemed the termination of the contract by Elektrociepłownia Stalowa Wola S.A. unlawful, and on February 12th 2016 submitted a termination notice itself.

On February 18th 2016, Elektrociepłownia Stalowa Wola S.A. began an as-built survey of the work performed by Abener Energia S.A. In H1 2016, PGNiG S.A. and Tauron Polska Energia S.A. held discussions on how the project should be continued and completed.

10.2. Planned activities

Sales of electricity and heat sales will be the main source of revenue for PGNiG TERMIKA S.A. in 2016. The main customer for electricity produced by PGNiG TERMIKA S.A. will be PGNiG S.A., while the main customer for heat will be Veolia Energia Warszawa S.A.

In addition, PGNiG TERMIKA S.A. also intends to develop the municipal heat distribution network in cooperation with Veolia Energia Warszawa S.A. The efforts aimed at expanding the area of heat distribution from the municipal network and increasing the number of new facilities connected to the network will offset lower heat consumption resulting from improved energy management by customers and thermal efficiency improvements.

In subsequent years, in line with the requirements of the PGNiG Group strategy, PGNiG TERMIKA S.A. will focus on enhancing the efficiency of its existing assets, while business development will be driven by acquisition of heating systems and, in economically justified cases, construction of new generating units. The company intends to focus on electricity production in high-performance cogeneration based on sources fired with gas, coal and biomass (including municipal waste) so as to diversify the fuel structure and generation technology, which will mitigate the risk related to changes in prices of fuel, electricity and CO_2 emission allowances.

In connection with the acquisition of PEC Jastrzębie S.A., as well as the planned acquisition of Spółka Energetyczna "Jastrzębie" S.A., PGNiG TERMIKA S.A. will continue operational consolidation of these companies' assets within the PGNiG Group.

10.3. Generation risks

<u>More stringent gas and dust emission standards</u>

In order to meet the more stringent gas and dust emission standards effective as of 2016, producers must thoroughly modernise their power and CHP plants and may be forced to shut down a number of generating units (to a total capacity 4,000-6,000 MWe) by 2020. Existing generating assets must be fitted with high-efficiency gas desulfurization units, or be replaced with low-emission installations. These modernization efforts and source substitution should be harmonised with BAT (Best Available Technology) environmental guidelines for large combustion plants.

<u>Maintaining share in the municipal heat market in Warsaw</u>

Following expansion of the Warsaw municipal waste incineration plant, the quantity of heat supplied to the city's municipal network will increase. As a result, PGNiG TERMIKA S.A.'s share in total heat supplies to the Warsaw municipal network will fall from the current 99.3%, to 96.5% in 2019.

Marketing efforts conducted jointly with Veolia Energia Warszawa S.A., and connecting further western districts of Warsaw to the municipal heating network should significantly reduce potential future decline in the volume of heat produced at PGNiG TERMIKA S.A.'s generating plants.

11. OTHER ACTIVITIES

11.1. Segment's activities

In H1 2016, the segment companies conducted work involving construction and assembly of gas transmission pipelines and gas compressor stations, construction and expansion of underground gas storage facilities and development of hydrocarbon deposits, as well as production of well equipment and spare parts and equipment for drilling rigs, drillships and construction machinery. The segment companies were also involved in the provision of repair services for well equipment, development of system designs, including for gas transport systems, and provision of hotel, restaurant and spa centre services.

The services offered by the segment were provided to both external customers and PGNiG Group companies. The key projects executed for external customers included:

- Construction of the Jeleniów II Gas Compressor Station for OGP GAZ-SYSTEM S.A.;
- Construction of the DN 1000 gas pipeline from Czeszów to Wierzchowice for OGP GAZ-SYSTEM S.A.;
- Construction of the Odolanów Gas Compressor Station (phase 0) and relocation of three compressors from Jeleniów to Odolanów for GAZ-SYSTEM S.A.;
- Preparation of design documentation for the project to construct the DN 100 high-pressure Zdzieszowice–Wrocław pipeline in the following sections: Brzeg–Ząbice–Kiełczów (46 km) and Zdzieszowice–Brzeg (84 km), for OGP GAZ-SYSTEM S.A.;
- Preparation of design documentation for and construction of a high-pressure gas metering station together with a compression unit in Sękocin Nowy for OGP GAZ-SYSTEM S.A.;
- Production of equipment and spare parts for drilling rigs and drillships for MHWirth AS (Norway).

Work performed by the segment's companies for external customers also included hotel, restaurant and spa centre services.

For PGNiG S.A., the segment performed chiefly construction and assembly contracts, the most important of which included:

- Extension of the Brzeźnica underground gas storage facility,
- Development of the Połęcko field; project completed,
- Development of the Rzeszów-20K well; project completed,
- Development of the Wilków-51K well; project completed,
- Development of the Gajewo crude oil deposit,
- Development of wells on the Brońsko field,

The segment's work for PGNiG S.A. also included continued manufacture of well equipment, such as production wellheads and casing heads, spare parts, as well as repairs of casing heads and wellheads.

The most important contracts executed for other PGNiG Group companies included:

- Extension of the Mogilno underground gas storage cavern facility;
- Construction work related to the construction of pipelines and leaching installation together with technical infrastructure as part of the 'Kosakowo − construction of five caverns, cluster B' project.

In addition, the segment's work for other PGNiG Group companies included production of well desanding equipment, spare parts for surface well equipment, preparation of gas infrastructure technical and design documents, as well as provision of technical and expert consulting services.

11.2. Planned activities

In 2016, the segment will continue construction and assembly work related to the construction of gas pipelines and gas infrastructure, as well as development of oil and gas assets and extension of underground gas storage facilities. The segment's companies intend to maintain their market positions in the manufacturing of equipment, including well surface equipment for conventional deposits, drilling platforms, equipment for oil and gas production facilities, and gas system design.

11.3. Risks related to other activities

Hydrocarbon prices

Low prices of natural gas and crude oil may prompt investors to withdraw from, postpone, or suspend new projects.

Legislation

Administrative regulations and procedures on the preparation of investment projects and obtaining building permits expose contractor to significant risks. In particular, regulations governing compliance with environmental requirements may significantly delay project execution and expose the segment to the risk of cost overruns caused by potential delays in contract performance, and to the risk of lower revenue. This also involves a legal risk in areas material for project execution, such as changes in construction, environment protection, or water laws. If the risk materialises, it may be necessary to change the scope of cooperation between parties, incur additional expenses, or obtain new permits and licences.

Competition

Companies offering construction, assembly services and design services, as well as manufacturers of drilling equipment are significantly exposed to growing competition from foreign companies (both those operating in their local markets abroad and those entering the Polish market) and from Polish market participants. Another major risk in this area is the growing competition from new business groups and international engineering corporations.

Qualified personnel

The growing competition from local and foreign companies on the Polish market leads to attrition of highly qualified employees with extensive professional experience who leave the PGNiG Group and take up employment with the competitors.

The segment takes measures to mitigate the risks, mainly by reducing operating costs (primarily overheads). Optimization of costs will allow the Company to partly offset lower revenue resulting from the challenging market environment, such as lower crude oil price or intensified competition.

12. CAPITAL EXPENDITURE

In H1 2016, capital expenditure incurred by the PGNiG Group on property, plant and equipment and intangible assets was PLN 1,106m, having decreased by ca. 8% year on year. The table below presents the Group's expenditure in the individual segments.

Capital expenditure (PLNm)

	H1 2016	H1 2015
Exploration and Production	566	708
Trade and Storage	89	107
Distribution	379	443
Generation	68	95
Other Activities	4	2
Total	**1,106**	**1,355**

Below are described the key capex projects implemented by the PGNiG Group in H1 2016.

Exploration and Production

The capital expenditure incurred in H1 2016 in the Exploration and Production Segment was PLN 566m. The expenditure of PGNiG S.A. on exploration work amounted to PLN 177m and was incurred chiefly on geophysical surveys and the drilling of hydrocarbon exploration and appraisal wells.

In H1 2016, the PGNiG Group's expenditure on gas and oil exploration and production work on the Norwegian Continental Shelf amounted to PLN 176m, the majority of which was spent on the development of the Gina Krog field.

The segment's other investment projects included the development of documented gas reserves (including already producing fields), projects executed to sustain or restore hydrocarbon production rates, and projects for the operation of the hydrocarbon production area. The key investment projects included:

- completion of development of the Połęcko oil and gas field, and of the Draganowa-1, Rzeszów-20, Pruchnik-27, Białoboki-1, and Siedleczka-2 wells,
- development of wells on the Brońsko field,
- development of the Sowia Góra-11K, Lubiatów-11H and Lubiatów-13K wells,
- development of wells on the Przeworsk field,
- start of development of the Radoszyn oil and gas field,
- development of the Gajewo crude oil deposit,
- development of the Karmingas field.

Trade and Storage

The capex of the Trade and Storage segment was PLN 89m. The key investment projects in H1 2016 included construction and extension of underground gas storage facilities, including:

- construction of the Kosakowo underground gas storage cavern facility – the leaching of K-6, K-8 and K-9 caverns was continued, preparatory work was carried out to fit-out the K-5 well for production purposes;
- extension of the Mogilno underground gas storage cavern facility – Z-13 well was placed in service as an observation well and the compressed air system was upgraded;
- extension of the Brzeźnica underground gas storage facility - start-up of the technological unit for uncompressed gas withdrawal and injection from the storage, and assembly of the linear part of the supply gas pipeline.

Distribution

Capital expenditure incurred by the PGNiG Group in the Distribution segment was PLN 379m, spent mainly on upgrading and extending the gas network and on connecting new customers. For a discussion of key projects in the Distribution segment, see Section VIII Distribution.

Generation

The coming into force of more stringent gas and dust emission standards in 2016 will necessitate modernisation of power plants and CHP plants operating in Poland. In order to meet the more stringent emission requirements, PGNiG TERMIKA S.A. is gradually modernising its generating assets. Capital expenditure of the Generation segment amounted to PLN 68m, of which approximately PLN 5m was spent on environmental protection projects. Furthermore, in H1 2016 the Generation segment continued some of the investment projects commenced in previous years. The most important of these were:

- Construction of a 450 MW CCGT unit at the Żerań CHP plant; in H1 2016, work on the alteration of the cooling water system and design work on adapting and connecting the existing equipment of the Żerań CHP plant to a new switchgear was carried out; the tender for construction of the CCGT unit was cancelled due to excessive prices; on July 25th 2016, a new invitation to bid was announced, with August 24th 2016 as the bid submission deadline;
- Conversion of the K1 boiler at the Siekierki CHP plant to biomass combustion; in H1 2016, start-up work at the boiler and biomass system was continued, and the system was approved for a trial run test; on April 1st 2016, licences for generation of electricity and heat based on combustion of biomass in a hybrid system were granted; the boiler will be placed in service in H2 2016;
- Conversion of the Pruszków CHP plant; in H1 2016, installation of cyclone filter at the K9 boiler and assembly work on cyclone filter at the K7 boiler were completed, and adjustment run of the cyclone filter equipment at the K7 boiler commenced; also, work on updating the concept for adaptation of the Pruszków CHP to operate beyond 2020 was carried out, and connecting the heating systems of Warsaw and Pruszków;
- Construction of a gas- and oil-fired peak-load and reserve boiler house at the Żerań CHP Plant; in H1 2016, bids placed in the tender for construction of the boiler house were analysed;
- Bringing the K2 steam generator at the Siekierki CHP plant in line with BAT (Best Available Technique) requirements in respect of dust, SO_2 and NO_x emissions; in H1 2016, design, construction and assembly work continued.

Other Activities

In H1 2016, the Other Activities segment incurred capital expenditure on property, plant and equipment and intangible assets of PLN 4m. The key investment projects included purchase of software, vehicles, buildings and structures, and production plant and equipment.

13. ENVIRONMENTAL PROTECTION

Well and extraction pit abandonment

Pursuant to the Polish Geological and Mining Law, PGNiG S.A. is required to properly abandon worked-out extraction pits, eliminate hazards and repair any damage caused by mineral extraction, and restore the land to its original condition. Plugging of wells and pits prevents leakage of crude oil and natural gas to the surface and into water courses. Furthermore, if gas wells remain unplugged, there is a risk that escaping gas could accumulate, posing a fire hazard. In H1 2016, a total of 4 wells and 17 extraction pits were abandoned.

Carbon credit trading system (*EU ETS)*

In H1 2016, the PGNiG Group reviewed annual reports on its carbon dioxide emissions for 2015. Carbon emissions from the installations covered by the EU ETS scheme in 2015 totalled 5,560,186 tonnes. After reconciling its CO_2 emissions with emission rights held, and after redeeming the allowances allocated for 2015, a deficit of 2,369,890 tonnes of CO_2 free emission units was identified. The deficit was covered with reserves accumulated in the accounts of the Group installations (unused free allocations from previous years) and with allowances purchased on the Intercontinental Exchange Futures Europe. In 2015, PGNiG TERMIKA S.A. (the Siekierki, Żerań and Pruszków CHP plants and the Kawęczyn and Wola heating plants), PGNiG Branches in Odolanów (gas compressor station, boiler house and process gas heaters) and Zielona Góra (LMG oil and gas production facility, Wierzchowice underground gas storage facility, boiler house, and Dębno oil and gas production facility), and the Mogilno and Kosakowo underground gas storage cavern facilities managed by Operator Systemu Magazynowania Sp. z o.o. were covered by the carbon dioxide emission trading scheme (ETS). In H1 2016, the Group emitted 3,075,397 tonnes of CO_2 from its installations.

In the current trading period (2013-2020), the free allocation of CO_2 emission allowances covers only a part of the actual emissions. The free allocations will decrease gradually, reaching zero in 2027.

Land reclamation and surveying of non-productive assets

Pursuant to the Environmental Protection Law, PGNiG S.A. conducts diagnostic tests, surveys and land reclamation work in areas polluted in the course of past activities, with a view to restoring them to the condition required under the environmental quality standards. In H1 2016, following amendments to the Environmental Protection Law, land properties underwent another review to classify them as requiring additional surveys, remediation, or monitoring.

Environmental impact of the Kosakowo underground gas storage cavern facility

One of the stages in the construction of the Kosakowo underground gas storage cavern facility consists in washing out (leaching) salt from halite deposits. The process creates brine, which is transported to the Puck Bay (Mechelinki region) through a pipeline equipped with diffusers releasing the brine 2,300 metres from the coastline at a rate of (average flow rate) Qav hour = 300 m^3/h and Qav day = 7,200 m^3/d, and with a salt concentration of 250 kg/m^3. The leaching of caverns at the Kosakowo underground gas storage cavern facility began in September 2010 and is scheduled for completion by 2021.

Land and sea monitoring activities are carried out in the vicinity of the Kosakowo underground gas storage cavern facility to assess the project's environmental impact. These activities are conducted as part of two programmes: the environmental monitoring programme (of May 2009) and the basic and emergency control programme for the Kosakowo underground gas storage cavern facility (of April 2014). The programmes cover the monitoring of underground and surface water, soil, vertical earth surface movements, the condition and operation of the brine discharge installation at the Kosakowo underground gas storage cavern facility, and the impact of the discharged brine on waters of the Puck Bay. The storage facility's tightness is also monitored by measuring soil air at selected locations. The surveys and observations conducted so far indicate that the operations of the Kosakowo underground gas storage cavern facility do not have a negative impact on the environment. The monitoring activities are conducted by independent bodies: the Maritime Institute of Gdańsk, the Institute of Hydroengineering of the Polish Academy of Sciences of Gdańsk, the Institute of

Oceanology of the Polish Academy of Sciences of Gdańsk, and the University of Gdańsk, as well as by the personnel of the Kosakowo underground gas storage cavern facility.

Reclamation of the fuel ash landfill site

PGNiG TERMIKA S.A. is carrying out reclamation of the Myśliborska fuel ash landfill site for the Żerań CHP plant. The project will involve reclamation of the land as green areas (Cells No. 1 and 2) and for residential and commercial development (Cell No. 3). In H1 2016, macrolevelling of surge tanks was completed, the site was tidied up, and the commissioning procedures were commenced. All of the reclamation work is scheduled to be completed in H2 2016.

Fulfilment of the requirements of the Industrial Emissions Directive and BAT

In H1 2016, in an effort to meet the environmental standards provided for in Directive 2010/75/EU of the European Parliament and of the Council on industrial emissions (IED) and future requirements related to the Best Available Techniques (BAT), PGNiG TERMIKA S.A. pursued projects designed to reduce atmospheric gas and dust emissions. In H1 2016, the Company completed conversion of five mazout-fired water boilers at the Siekierki CHP plant (K8 and K9) and the Wola heating plant (K2, K3, K4) into light oil units, including modernisation of their burners. In environmental terms, the project will reduce SO_2 concentration from 1,300–1,500 mg/Nm^3 to below 200 mg/Nm^3. Total expenditure on the project was approximately PLN 57.9m.

In H1 2016, PGNiG TERMIKA S.A. also continued work on:

- Conversion of the coal-fired K1 boiler at the Siekierki CHP plant into a biomass-fired unit; start-up work was carried out; electricity required to obtain green certificates was produced and licences to produce electricity and heat based on biomass combustion were obtained; the expected annual reduction of pollutants into the atmosphere comprises reduction of CO_2 emissions by 227,000 tonnes, of SO_2 emissions − by 780 tonnes, of NO_x emissions − by 260 tonnes and of particulate matter emissions − by 20 tonnes; the unit is expected to be placed in service in H2 2016;
- Fitting out the fluidised bed boilers at the Żerań CHP plant with high efficiency dust collectors (bag filters) and improving the efficiency of the desulfurisation process; in environmental terms, the project will reduce dust concentration from ca. 50–100 mg/Nm^3 to below 20 mg/Nm^3 and SO_2 concentration from 500 mg/Nm^3 to below 200 mg/Nm^3; the entire project is scheduled for completion in H2 2016;
- Fitting of a nitrogen oxides reduction system at the K16 boiler at the Siekierki CHP plant; in environmental terms, the project will reduce NO_x concentration from approximately 400 mg/Nm^3 to 220 mg/Nm^3, assuming the system operates at full capacity; the project is scheduled for completion in 2017;
- Upgrade of the atmosphere protection system at the Siekierki CHP plant's steam generator No. 2; under the project, the existing semi-dry flue gas desulfurisation unit will be upgraded and a nitrogen oxides reduction system will be added; the project will reduce SO_2 emissions by 374 tonnes annually and NO_x emissions by 162.6 tonnes annually; in H1 2016, design, construction and assembly work was carried out; the project is scheduled for completion in 2017;
- Replacement of cyclones with cyclone filters as dust collectors on two boilers (No. 7 and 9) at the Pruszków CHP; in environmental terms, the replacement will reduce dust concentration from approximately 150-200 mg/Nm^3 to below 100 mg/Nm^3.

In H1 2016, a contract for fitting of an NOx reduction system at the K5, K6, K7 and K16 water boilers at the Siekierki CHP plant was abandoned due to inability to reach the required emission levels with the use of the technical solutions proposed by the contractor.

Biomass supplies and consumption

In performance of the requirements stipulated in Directive 2009/28/EC on the promotion of the use of energy from renewable sources, PGNiG TERMIKA S.A. acquires biomass primarily from purchases contracted on the market. The company also concludes long-term contracts for the supply of biomass from energy willow plantations. Currently, the company procures biomass from plantations with a total area of 407 ha. In H1 2016, the amount of biomass co-combusted or combusted at PGNiG TERMIKA S.A. was 1,168 tonnes (Żerań CHP plant) and 115,505 tonnes (Siekierki CHP plant), respectively. Thanks to the use of biomass as a fuel, in H1 2016 CO_2 emissions from fossil fuels were reduced by 103,076 tonnes.

14. OTHER INFORMATION

Distribution of the 2015 profit

On June 28th 2016, the Annual General Meeting of PGNiG S.A. passed a resolution to distribute the 2015 net profit of PLN 1,472m. The profit was distributed as follows:

- PLN 1,062m was allocated for dividend payments (dividend per share of PLN 0.18).
- PLN 410m was allocated to the Company's statutory reserve funds.

The Annual General Meeting of PGNiG S.A. set July 20th 2016 as the dividend record date and August 2nd 2016 as the dividend payment date.

Discharge

On June 28th 2016, the Annual General Meeting of PGNiG S.A. approved the financial statements and the Directors' Report on the operations of PGNiG S.A., as well as the consolidated financial statements and the Directors' Report on the operations of the PGNiG Group. The Annual General Meeting of PGNiG S.A. also granted discharge in respect of their duties in the financial year 2015 to Mr Piotr Woźniak, President of the Management Board (delegated to temporarily perform the duties of a member of the PGNiG Management Board), and the following members of the PGNiG Supervisory Board:

- Wojciech Bieńkowski,
- Stanisław Borowiec,
- Mateusz Boznański,
- Andrzej Gonet,
- Maciej Mazurkiewicz,
- Grzegorz Nakonieczny,
- Krzysztof Rogala,
- Ryszard Wąsowicz,
- Magdalena Zegarska.

The Annual General Meeting of PGNiG S.A. did not grant discharge to former members of the PGNiG Management Board − Mariusz Zawisza, President of the Management Board, Vice Presidents Jarosław Bauc, Zbigniew Skrzypkiewicz, Waldemar Wójcik, and members of the PGNiG Supervisory Board – Wojciech Chmielewski, Agnieszka Woś, Irena Ożóg, Andrzej Janiak, and Janusz Pilitowski.

Acquisition of shares in Polska Grupa Górnicza Sp. z o.o.

On April 26th 2016, PGNiG TERMIKA S.A. signed an agreement to launch operations of Polska Grupa Górnicza Sp. z o.o. (PGG). The parties to the Agreement are PGNiG TERMIKA S.A., Kompania Węglowa S.A., Polska Grupa Górnicza Sp. z o.o., Węglokoks S.A., Towarzystwo Finansowe Silesia Sp. z o.o. ("TFS"), Fundusz Inwestycji Polskich Przedsiębiorstw Fundusz Inwestycyjny Zamknięty Aktywów Niepublicznych, Energa Kogeneracja Sp. z o.o., PGE Górnictwo i Energetyka Konwencjonalna S.A. (the "Investors"), and banks: Alior Bank S.A., Bank BGŻ BNP Paribas S.A., Powszechna Kasa Oszczędności Bank Polski S.A., Bank Zachodni WBK S.A., Bank Gospodarstwa Krajowego S.A., and trade unions operating at Kompania Węglowa S.A. (jointly the "Parties").

In the Agreement, the Investors have undertaken to purchase PGG shares for a total amount of PLN 2.4bn, of which PLN 1.8bn is to be contributed in cash and the balance in the form of conversion of TFS's and Węglokoks S.A.'s claims into equity. PGNiG TERMIKA S.A. has undertaken to purchase PGG shares for PLN 500m. Financial creditors of PGG participated in negotiations leading to the execution of the Agreement. As part of refinancing of Kompania Węglowa S.A.'s current bond issue programme, the banks and Węglokoks S.A. have undertaken to acquire new bonds issued by PGG for PLN 1,037m, in three tranches to be redeemed in 2019−2026, with Węglokoks S.A. committing to acquire bonds worth PLN 421.5m, and the banks committing to acquire bonds worth PLN 615.5m.

Further to an agreement of April 26th 2016, on April 28th 2016 PGNIG TERMIKA S.A. and other Investors signed an investment agreement setting out the terms of their investment in Polska Grupa Górnicza Sp. z o.o. The agreement provides for a three-stage acquisition of new PGG shares by PGNiG TERMIKA S.A., up to 17.1% (5,000,000 shares) of PGG's share capital, for the amount of PLN 500m declared in the agreement. Stages two and three will be executed on condition that there PGG does not default on any of the terms and conditions of the notes issue.

On April 29th 2016, the Extraordinary General Meeting of Polska Grupa Górnicza Sp. z o.o. passed a resolution to increase the company's share capital from PLN 500,050,000 to PLN 2,305,607,200 through issuance of 18,055,572 new shares with a par value of PLN 100 per share. As part of the increase, at the same date PGNiG TERMIKA S.A. acquired 3,611,100 shares, which represents 15.66% of PGG's share capital and total voting rights. The share capital increase was registered with the National Court Register on July 25th 2016.

Polska Grupa Górnicza Sp. z o.o. will conduct its business using selected mining assets acquired from Kompania Węglowa S.A. (11 mines, four plants, and mine and plant support functions). PGG will operate based on a business plan (approved by the Parties and attached to the Investment Agreement as an appendix) created to maintain strict control of coal production cost, improve the company's efficiency, and achieve assumed profitability level. It is assumed that PGG's proceeds received under the Investment Agreement and from the note issue will be sufficient for PGG to continue trading, and that no further financing will be required. The Investment Agreement contains provisions that allow Investors to monitor PGG's financial position and, in particular, progress of the business plan on an ongoing basis.

On June 17th 2016, PGNiG TERMIKA S.A. signed an agreement with PGE Górnictwo i Energetyka Konwencjonalna S.A., Energa Kogeneracja Sp. z o. o., and Fundusz Inwestycji Polskich Przedsiębiorstw Fundusz Inwestycyjny Zamknięty Aktywów Niepublicznych, concerning acquisition of joint control over PGG. On June 29th 2016, PGNiG TERMIKA S.A. received clearance for acquisition of joint control over the company from the Office of Competition and Consumer Protection.

Proceedings before the President of the Office of Competition and Consumer Protection (UOKiK)

On December 28th 2010, the President of the Polish Office of Competition and Consumer Protection ("UOKiK") instigated, ex officio, anti-trust proceedings concerning alleged abuse by PGNiG S.A. of its dominant position on the domestic natural gas wholesale market, which consisted in inhibiting trade in natural gas against the interests of trading partners or consumers and in impeding the development of market conditions necessary for the emergence or development of competition by refusing to sell gas fuel under a comprehensive supply contract to an entrepreneur that intended to resell the gas, i.e. NowyGaz Sp. z o.o. of Warsaw. In its decision of July 5th 2012, the President of UOKiK found these actions to be anti-competitive practices, concluded that PGNiG S.A. discontinued those practices as of November 30th 2010, and imposed on the Company a fine of PLN 60m. On July 24th 2012, PGNiG S.A. appealed against the decision to the Competition and Consumer Protection Court at the Regional Court of Warsaw. In the judgement of May 12th 2014, the Regional Court of Warsaw dismissed the appeal. On June 4th 2014, PGNiG S.A. appealed against the decision to the Warsaw Court of Appeals. In the judgement of May 29th 2015, the Court of Appeals amended the decision of the President of UOKiK where it referred to the amount of the fine by reducing the fine to PLN 5.5m. The judgment is final. On June 12th 2015, PGNiG S.A. paid the penalty imposed by the judgment of the Warsaw Court of Appeals. Both PGNiG S.A. and the President of UOKiK filed cassation complaints against the Court of Appeals' judgment to the Supreme Court. PGNiG S.A.'s cassation complaint seeks to challenge the finding of competition law infringement, whereas the President of UOKiK's cassation complaint seeks to question the Court of Appeal's decision to reduce the penalty imposed on PGNiG S.A. As at the date of this report, the Supreme Court had not examined the matter.

On April 3rd 2013, the President of UOKiK instigated anti-trust proceedings concerning alleged abuse by PGNiG S.A. of its dominant position on the domestic wholesale and retail natural gas market, which consisted in impeding the development of market conditions necessary for the emergence or development of competition by:

- limiting the ability of business customers to reduce the contracted volumes of gas fuel and capacity,
- limiting the ability of business customers to resell gas fuel,
- requiring that business customers define the maximum volume of gas fuel purchased for resale in the contract,
- refusing to grant wholesale customers the right to a partial change of supplier.

In the course of the proceedings, PGNiG S.A. voluntarily agreed to revise certain provisions in contracts with its non-household customers. By virtue of a decision of December 31st 2013, the President of UOKiK resolved not to impose a fine on the Company and obliged the Company to fulfil its commitment. PGNiG S.A. performed its obligations set out in the President of UOKiK's commitment decision within the deadlines specified therein. On August 1st 2014, PGNiG Obrót Detaliczny Sp. z o.o. took over the existing retail gas trading business from PGNiG S.A. and assumed all the rights and obligations arising from the decisions issued by the President of UOKiK under the Act on Competition and Consumer Protection of February 16th 2007 (consolidated text: Dz.U. of 2015, item 184) in respect of agreements and contracts to which PGNiG Obrót Detaliczny Sp. z o.o. became a party. PGNiG Obrót Detaliczny Sp. z o.o. performed in full (to the extent corresponding to its scope of business) the obligations set forth in the conclusion of President of UOKiK's decision of December 31st 2013.

On October 17th 2014, the President of UOKiK commenced administrative proceedings to impose a fine under Art. 107 of the Act on Competition and Consumer Protection on PGNiG S.A. and PGNiG Obrót Detaliczny Sp. z o.o. for alleged delay in complying with Section I).4) of the conclusion of the President of UOKiK's decision of December 31st 2013. In their response, PGNiG S.A. and PGNiG Obrót Detaliczny Sp. z o.o. presented grounds for their actions and their position whereunder such actions comply with Section I).4) of the conclusion of the President of UOKiK's decision of December 31st 2013.

On September 24th 2015, the President of UOKiK issued a decision stating that PGNiG S.A. had not fully implemented Section I).4) of the decision of December 31st 2013 and imposed on the Company a fine of PLN 10.4m for the delay in complying with the decision. Concurrently, in the same decision the President of UOKiK discontinued the administrative proceedings with respect to PGNiG Obrót Detaliczny Sp. z o.o., claiming that the company had met the obligation specified in the decision of December 31st 2013. On November 2nd 2015, PGNiG S.A. appealed against the decision to the Competition and Consumer Protection Court at the Regional Court of Warsaw. As at the date of this report, the Competition and Consumer Protection Court had not notified PGNiG S.A. of a hearing date.

Proceedings with a value in excess of 10% of the Company's equity

In H1 2016, neither PGNiG S.A. nor its subsidiaries were engaged in any proceedings before a court, arbitration tribunal or administrative authority concerning liabilities or claims whose value (whether in any single case or in two or more cases jointly) would represent at least 10% of the Company's equity.

15. FINANCIAL STANDING

The interim condensed consolidated financial statements of the PGNiG Group and the interim condensed separate financial statements of PGNiG S.A. for the six months ended June 30th 2016 have been prepared in accordance with the International Financial Reporting Standards (IFRS) as endorsed by the European Union as at June 30th 2016. The policies applied to prepare these interim condensed consolidated financial statements and interim condensed separate financial statements are consistent with the general policies applied to draw up the full-year consolidated financial statements for the year ended December 31st 2015, issued on March 4th 2016, except that the amendments to financial reporting standards and new interpretations effective for annual periods beginning on or after January 1st 2016, described in Section III.4 of the PGNiG Group's interim report for H1 2016, have been applied.

15.1 Financial data of the Parent

Summary information on PGNiG S.A.'s financial performance in H1 2016 is presented below.

Key financial results (PLNm)

	H1 2016	H1 2015
Revenue	**8,864**	**10,223**
Total operating expenses, including	(8,419)	(9,188)
Depreciation and amortisation	(396)	(359)
Operating profit	445	1,035
Profit before tax	2,080	1,912
Net profit	1,974	1,703
Net cash (used in)/generated by operating activities	998	1,073
Net cash (used in)/generated by investing activities	(859)	557
Net cash (used in)/generated by financing activities	599	163
Net increase/(decrease) in cash and cash equivalents	738	1,793
	Jun 30 2016	Dec 31 2015
Total assets	**37,747**	**35,027**
Non-current assets	25,937	26,137
Current assets, including	11,810	8,890
Inventories	1,429	1,638
Other assets	88	18
Total equity	24,962	23,738
Total non-current liabilities	2,603	7,205
Total current liabilities	10,182	4,084
Total liabilities	**12,785**	**11,289**
Total equity and liabilities	**37,747**	**35,027**

Financial ratios

Profitability

	H1 2016	2015
EBIT (PLNm) operating profit	445	1,035
EBITDA (PLNm) operating profit + depreciation/amortisation	841	1,394
ROE net profit to equity at end of period	7.9%	7.2%
Net margin net profit to revenue	22.3%	16.7%
ROA net profit to assets at end of period	5.2%	4.9%

Liquidity

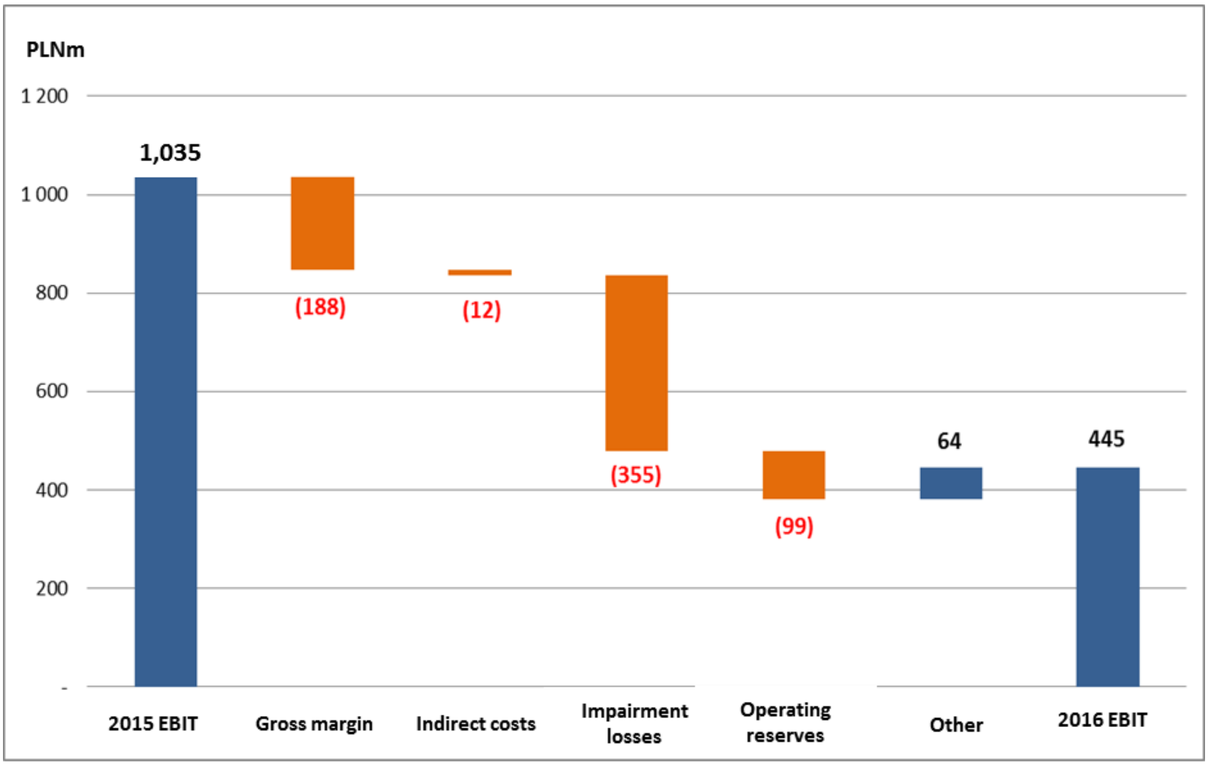
	Jun 30 2016	Dec 31 2015
Current ratio current assets to current liabilities (net of employee benefit obligations, provisions and deferred revenue)	1.2	2.5
Quick ratio current assets less inventories to current liabilities (net of employee benefit obligations, provisions and deferred revenue)	1.1	2.0

Debt

	Jun 30 2016	Dec 31 2015
Debt ratio total liabilities to total equity and liabilities	33.9%	32.2%
Debt/equity ratio total liabilities to equity	51.2%	47.6%

In H1 2016, PGNiG S.A.'s operating profit (EBIT) came in at PLN 445m, down PLN 590m year on year. The chart below presents changes in EBIT from H1 2015 to H1 2016.

Change in EBIT: H1 2015 vs H1 2016



The PLN 188m year-on-year contraction of gross margin (difference between revenue and direct costs) was mainly attributable to:

- lower margin on sales of crude oil due to lower average selling prices of the crude. The difference between prices of Brent crude as at the end of June 2015 and as at the end of June 2016 was about 20%;
- lower margin on provision of services, in particular on storage system operator services, mainly due to the reduced rate of return on the regulatory value of assets.

The decreases were partly offset by higher gross margin on sales of high-methane gas, primarily on a lower purchase price of imported gas.

The margins on sales of the other products, including electricity, helium and LPG, were similar to the margins in H1 2015.

The gross margin further deteriorated at the operating profit (EBIT) level due to the following factors:

- higher impairment losses, in particular on the property, plant and equipment associated with hydrocarbon exploration and production;
- higher operating reserves (mainly due to creation of provisions for well decommissioning costs).

In H1 2015, net finance income/(cost) increased PLN 758m year on year, driven by a PLN 795m increase in dividends from subsidiaries.

The Company's financial position was reflected in its key financial ratios. ROE, ROA and net margin increased from 7.2% to 7.9%, from 4.9% to 5.2% and from 16.7% to 22.3%, respectively.

15.2. Key financial results of the PGNiG Group

15.2.1. Key financial and business data

Summary information on the PGNiG Group's financial standing in H1 2016 is presented below, in the financial statements prepared in accordance with the International Financial Reporting Standards, which comprise:

- condensed consolidated statement of financial position,
- condensed consolidated statement of profit or loss,
- condensed consolidated statement of cash flows,
- selected financial ratios.

Consolidated statement of financial position (PLNm)

	As at Jun 30 2016	As at Dec 31 2015
ASSETS		
Non-current assets		
Property, plant and equipment	32,539	32,967
Investment property	10	12
Intangible assets	1,074	1,138
Investments in equity-accounted entities	1,160	840
Other financial assets	280	275
Deferred tax assets	1,350	1,575
Other non-current assets	148	152
Total non-current assets	**36,561**	**36,959**
Current assets		
Inventories	1,973	2,229
Trade and other receivables	2,397	3,372
Current tax assets	28	7
Other assets	409	146
Derivative financial instrument assets	551	709
Cash and cash equivalents	8,115	6,239
Assets held for sale	163	164
Total current assets	**13,636**	**12,866**
Total assets	**50,197**	**49,825**
EQUITY AND LIABILITIES		
Equity		
Share capital	5,900	5,900
Share premium	1,740	1,740
Accumulated other comprehensive income	(332)	(637)
Retained earnings/(deficit)	23,942	23,733
Equity attributable to owners of the parent	**31,250**	**30,736**
Equity attributable to non-controlling interests	5	5
Total equity	**31,255**	**30,741**
Non-current liabilities		
Borrowings and other debt instruments	1,382	5,799
Employee benefit obligations	654	565
Provisions	1,751	1,728
Deferred revenue	1,494	1,511
Deferred tax liabilities	3,055	3,090
Other non-current liabilities	73	102
Total non-current liabilities	**8,409**	**12,795**
Current liabilities		
Trade and other payables	3,602	3,288
Borrowings and other debt instruments	5,040	583
Derivative financial instrument liabilities	676	1165
Current tax liabilities	145	53
Employee benefit obligations	369	352
Provisions	548	694
Deferred revenue	153	154
Total current liabilities	**10,533**	**6,289**
Total liabilities	**18,942**	**19,084**
Total equity and liabilities	**50,197**	**49,825**

Consolidated statement of profit or loss (PLNm)

	H1 2016	H1 2015
Revenue	**17,349**	**20,390**
Raw materials and consumables used	(11,256)	(13,724)
Employee benefits expense	(1,184)	(1,281)
Depreciation and amortisation	(1,337)	(1,387)
Services	(1,141)	(1,278)
Work performed by the entity and capitalised	324	435
Other income and expenses	(961)	(546)
Total operating expenses	**(15,555)**	**(17,781)**
Operating profit/(loss)	**1,794**	**2,609**
Finance income	136	50
Finance costs	(156)	(108)
Share in net profit/(loss) of equity-accounted entities	(41)	
Profit/(loss) before tax	**1,733**	**2,551**
Income tax	(462)	(686)
Net profit/(loss)	**1,271**	**1,865**
Attributable to:		
Owners of the parent	1,271	1,864
Non-controlling interests		1
Earnings/(loss) and diluted earnings/(loss) per share attributable to holders of ordinary shares of the parent (PLN)	0.22	0.32

Consolidated statement of cash flows (PLNm)

	H1 2016	H1 2015
Net cash (used in)/generated by operating activities	3,763	4,629
Net cash (used in)/generated by investing activities	(1,821)	(1,510)
Net cash (used in)/generated by financing activities	(65)	(639)
Net increase/(decrease) in cash and cash equivalents	**1,877**	**2,480**
Cash and cash equivalents at beginning of period	6,238	2,956
Cash and cash equivalents at end of period	**8,115**	**5,436**

Financial ratios

Profitability

	H1 2016	2015
EBIT (PLNm) operating profit	1,794	2,609
EBITDA (PLNm) operating profit + depreciation/amortisation	3,131	3,996
ROE net profit* to equity at end of period**	4.1%	6.1%
Net margin net profit* to revenue	7.3%	9.1%
ROA net profit* to assets at end of period	2.5%	3.7%

* net profit attributable to owners of the parent
** equity attributable to owners of the parent

Liquidity

	Jun 30 2016	Dec 31 2015
Current ratio current assets to current liabilities (net of employee benefit obligations, provisions and deferred revenue)	1.4	2.5
Quick ratio current assets less inventories to current liabilities (net of employee benefit obligations, provisions and deferred revenue)	1.2	2.1

Debt

	Jun 30 2016	Dec 31 2015
Debt ratio total liabilities to total equity and liabilities	37.7%	38.3%
Debt/equity ratio total liabilities to equity*	60.6%	62.1%

* equity attributable to owners of the parent

15.2.2. Financial standing

In H1 2016, the PGNiG Group posted revenue of PLN 17,349m, down by PLN 3,041m (or 15%) on the corresponding period of the previous year, when the revenue came in at PLN 20,390m. With costs lower by PLN 2,226m (or 13%), in H1 2016 the Group posted consolidated operating profit of PLN 1,794m, while its operating profit before amortisation/depreciation (EBITDA) came in at PLN 3,131m, down by PLN 865m year on year. The decrease was mainly attributable to macroeconomic factors (lower crude oil prices on global markets) and the ongoing deregulation of the Polish gas market.

Exploration and Production

At the end of H1 2016, the Exploration and Production segment reported an operating loss of PLN 80m, a decrease by PLN 927m relative to the operating profit earned in the corresponding period of 2015. The segment's EBITDA came in at PLN 495m, and was by PLN 1,047m (or 68%) lower than the EBITDA generated in the same period of the previous year.

The segment's revenue decreased by PLN 395m (16%) year on year, to PLN 2,138m, despite a 2% increase in the volume of crude oil sales. The revenue decline reflected the fall in crude oil prices (in Polish zloty terms, the average price of Brent in H1 2016 was approximately 27% lower than in H1 2015).

The PLN 532m increase in the Exploration and Production segment's operating expenses (up 32%) was caused by higher impairment losses on non-current, which in H1 2016 amounted to PLN 657m, compared with PLN 157m a year earlier. In addition, in H1 2016 the provision for wells and pits decommissioning costs and the Extraction Facility Decommissioning Fund was increased to PLN 5m, while in the corresponding period of the previous year a reversal of the provision reduced costs by PLN 140m.

The Exploration and Production segment's expenses were also affected by lower depreciation and amortisation, down from PLN 695m in H1 2015, to PLN 575m in H1 2016. The decline resulted from the revaluation of reserves on the Norwegian Continental Shelf, which reduced depletion rates applied to producing assets.

<u>Trade and Storage</u>

In H1 2015, the Trade and Storage segment earned operating profit of PLN 646m, down PLN 95m on PLN 741m reported for the corresponding period of 2015.

In H1 2016, the segment earned revenue of PLN 14,883m, i.e. PLN 2,941m (16.5%) less than in the corresponding period of the previous year, which combined with a PLN 2,846m (16.7%) year-on-year decrease in the segment's expenses led to the decrease in the operating profit.

The lower operating profit was a result of the ongoing deregulation of the Polish gas market, which allows the segment's largest customers to diversify their gas fuel supplies. In H2 2015 and H1 2016, PGNiG S.A. and PGNiG OD made several revisions to their gas fuel tariffs. As a result, the average tariff price in H1 2016 was lower by ca. 12% compared with H1 2015. Additionally, in response to the changing market conditions, the segment companies selling gas fuel in Poland continued to introduce discount schemes to make their offering more attractive to customers.

Despite an increase in the volume of gas fuel sales (up by 3.8% yoy) and the lower gas procurement costs (nearly 31% decline of the average price of gas fuel on West European exchanges, affecting costs of the gas imported from countries east of Poland), the discount programmes and the lower gas tariffs affected the Trade and Storage segment's operating profit for H1 2016.

As at June 30th 2016, the Group held ca. 1.6 bcm of gas in underground storage – approximately 11% down on the corresponding period last year.

<u>Distribution</u>

The Distribution segment's operating profit in H1 2016 increased 24% year on year, to PLN 968m, while EBITDA came in at PLN 1,423m, up by PLN 205m year on year. The improvement resulted from both lower expenses and stronger revenue streams. In H1 2016, expenses decreased by PLN 121m (7%) while revenue increased by PLN 68m (3%) compared with the same period a year earlier.

The decline in the segment's expenses was primarily attributable to a significant reduction of employee benefits expense following the 2015 workforce streamlining as part of the Voluntary Redundancy Programme. The significant reduction in employee benefits in H1 2016 relative to the same period the year before resulted from the fact that in H1 2015 employee benefits included a PLN 96m cost of workforce streamlining and the Voluntary Redundancy Programme.

The higher revenue in H1 2016 was achieved due to a 5% increase in the volume of distributed natural gas.

<u>Generation</u>

The segment's operating profit in H1 2016 was PLN 274m, having increased by PLN 23m year on year. EBITDA was PLN 450m, an improvement of PLN 38m (9%) on H1 2015. The following factors contributed to the improvement:

- higher revenue from sales of heat due to an increase in the volume of heat sales (up 3% in H1 2016 vs H1 2015) and the higher heat tariff (5% increase on average in August 2015);
- lower procurement costs of coal, the segment's main fuel for heat production (the average price of coal in H1 2016 was 7% lower than in the same period of the previous year).

Operating performance by segment

Key financial results of the PGNiG Group's segments for H1 2016 (PLNm)

Period ended Jun 30 2016	Exploration and Production	Trade and Storage	Distribution	Generation	Other Activities	Eliminations	Total
Sales to external customers	1,378	14,715	463	730	63		17,349
Inter-segment sales	760	168	1,999	393	57	(3,377)	0
Segment's total revenue	2,138	14,883	2,462	1,123	120	(3,377)	17,349
Segment's expenses	(2,218)	(14,237)	(1,494)	(849)	(141)	3,384	(15,555)
Operating profit/(loss)	**(80)**	**646**	**968**	**274**	**(21)**	**7**	**1,794**
Net finance costs							(20)
Share in net profit/(loss) of equity-accounted entities	(41)	-	-	-	-	-	(41)
Profit/(loss) before tax							**1,733**
Income tax							(462)
Net profit/(loss)							**1,271**

Financial data of the PGNiG Group's segments for H1 2015 (PLNm)

Period ended Jun 30 2015	Exploration and Production	Trade and Storage	Distribution	Generation	Other Activities	Eliminations	Total
Sales to external customers	1,704	17,660	260	669	97	0	20,390
Inter-segment sales	829	164	2,134	362	64	(3,553)	0
Segment's total revenue	2,533	17,824	2,394	1,031	161	(3,553)	20,390
Segment's expenses	(1,686)	(17,083)	(1,615)	(780)	(165)	3,548	(17,781)
Operating profit/(loss)	**847**	**741**	**779**	**251**	**(4)**	**(5)**	**2,609**
Net finance costs							(58)
Share in net profit/(loss) of equity-accounted entities	-	-	-	-	-	-	0
Profit/(loss) before tax							**2,551**
Income tax							(686)
Net profit/(loss)							**1,865**

In H1 2016, the Group reported a PLN 38m increase in net finance cost (net finance cost of PLN 20m compared with PLN 58m a year earlier), mainly due to improved result on valuation of derivatives associated with the Group's financing activities and higher interest income earned on cash at banks.

Pre-tax profit was further reduced by the valuation of shares in Polska Grupa Górnicza Sp. z o.o., whose loss for the period during which the PGNiG Group exercised significant influence over the company reduced the Group's pre-tax profit by PLN 41m.

As a result, in H1 2016 the PGNiG Group posted a net profit of PLN 1,271m, down PLN 594m (32%) year on year.

Statement of financial position

As at June 30th 2016, total assets recognised in the consolidated statement of financial position were PLN 50,197m, up PLN 372m (0.8%) on the end of 2015.

Assets

The largest item of the Group's assets was property, plant and equipment, which stood at PLN 32,539m at the end of H1 2016, down by PLN 428m (1.3%) from December 31st 2015, mainly due to the impairment losses recognised on those assets (the balance of impairment losses rose by PLN 665m year on year).

Deferred tax assets, the second largest item of non-current assets, decreased by PLN 225m (or 14,3%) on realisation of tax loss in Norway by subsidiary PGNiG Upstream International AS (PUI) (the tax loss has been accounted for since the launch of hydrocarbon production from the Skarv field).

Investments in equity-accounted entities rose by PLN 320m (or 38.1%) year on year, following the purchase of shares in Polska Grupa Górnicza Sp. z o.o. (the transaction, effected through subsidiary PGNiG TERMIKA S.A., took place in April 2016; the amount paid for the shares was PLN 361.1m).

As at the end of H1 2016, the Group's current assets were PLN 13,636m, up PLN 770m (or 6%) relative to the end of 2015. Cash was the largest contributing item, having risen by PLN 1,876m (or 30.1%) year on year, mainly on the financial result of the current period and a decrease in trade and other receivables (down by PLN 975m (or 28.9%) on the end of 2015; this is an effect of seasonality of gas fuel sales, with volumes peaking in the autumn and winter seasons, when receivables are higher reflecting higher sales volumes).

Equity and liabilities

Equity is the main source of financing of the Group's assets. At the end of H1 2016, the Group's equity was PLN 31,255m, up by PLN 514m (or 1.7%) relative to 2015. The change in equity was primarily attributable to the net profit earned in the reporting period, of PLN 1,271m, adjusted for the PLN 1,062m dividend to be paid for the previous year (as per AGM resolution). For the remaining part, the change in equity was due to net other comprehensive income, which came in at PLN 305m for H1 2016.

As at June 30th 2016, non-current liabilities were PLN 8,409m, down PLN 4,386m (or 34.3%) on the end of December 2015. Such a considerable decline was due to the reclassification of liabilities under debt securities (PLN 4,581m) which mature in H1 2017 as non-current.

As at June 30th 2016, the PGNiG Group carried current liabilities of PLN 10,533m, up PLN 4,244m (67.5%) relative to the end of 2015. The increase was due to the reclassification of some of the debt under debt securities from non-current to current, as referred to above.

In connection with the increase in equity and the concurrent decline in the total of non-current and current liabilities, the Group saw an improvement in its debt to equity and debt ratios. The debt to equity ratio and the debt ratio decreased from 62.1% to 60.6% and from 38.3% to 37.7%, respectively.

The reclassification of liabilities under debt securities as current led to a decrease in liquidity ratios: current ratio decreased to 1.4, from 2.5 at the end of December 2015, while the quick ratio was 1.2 in the reported period, compared with 2.1 at the end of the previous year.

Transactions concluded on non-arm's length terms

In H1 2016, no transactions were concluded on non-arms' length terms between related entities of the PGNiG Group.

Feasibility of meeting published performance forecasts

The PGNiG Management Board did not publish any forecasts of the PGNiG Group's performance for 2016.

Guarantees and sureties

In H1 2016, neither PGNiG S.A. nor any of its subsidiaries issued any sureties with respect to borrowings or any guarantees where the total amount of such sureties or guarantees provided for the benefit of a single entity would represent 10% or more of the provider's equity.

15.3. Expected future financial standing

In the coming periods, the financial standing of the PGNiG Group will be materially affected by changes in prices of hydrocarbons on global commodity markets and fluctuations of foreign exchange rates. These factors will have an effect on financial results of the Exploration and Production segment and the Trade and Storage segment of the PGNiG Group.

Falling prices of crude translate into lower revenue earned by the PGNiG Group companies engaged in crude production and sale, and into lower demand for seismic and exploration services offered by the Group companies, and in consequence have a negative effect on the results posted by the Group’s Exploration and Production segment. Over the coming quarters lower prices of crude may also be expected to necessitate recognition of further impairment losses on hydrocarbon producing assets, which would adversely affect the segment’s financial performance.

Given the relation between prices of hydrocarbons and the price of natural gas purchased by the Group under the long-term contracts with OOO Gazprom eksport and Qatar Liquefied Gas Company Limited (3), lower hydrocarbon prices will have a positive effect on PGNiG S.A.’s gas procurement costs and consequently on financial results of the Group’s Trade and Storage segment.

The PGNiG Group’s financial results will also be materially affected by the situation on the domestic currency market. Any strengthening of the zloty against foreign currencies (primarily the US dollar) will have a positive effect on the performance of the Trade and Storage segment by driving down PGNiG S.A.’s gas procurement costs. However, the PGNiG Group has in place a hedging policy which helps optimise the impact of exchange rate fluctuations.

The PGNiG Group’s financial results will also be affected by the position of the President of URE regarding the level of gas fuel sale and distribution tariffs and heat sale tariffs. In addition, the progressing deregulation of the gas market in Poland will continue to put pressure on the performance of the PGNiG Group Trade and Storage companies engaged in the provision of gas sale services. Competition for customers has prompted the launch of a number of discount schemes for customers buying gas from the Group. These factors have had an adverse effect on the profitability of the Trade and Storage segment by eroding its margins.

However, the Group companies have put in place a number of initiatives to improve their efficiency. These initiatives focus, among other things, on optimisation of the cost base and are expected to have a positive effect on the PGNiG Group’s financial results.

In the case of the Generation segment, the Group’s performance will also be considerably affected by the support programmes for electricity from high-efficiency co-generation and renewable sources. Legislative changes in this area and fluctuations in market prices of certificates of origin (both red and green) will have a bearing on the segment’s financial position. Another key factor affecting the performance of the Generation segment relates to prices of the fuels used to produce heat and electricity.

In the coming quarters, the Group intends to maintain a high level of capital expenditure, with spending focused on expansion of the underground storage capacities, maintenance of hydrocarbon production rates, oil and gas exploration and appraisal projects, and development of the power generation segment.

Members of the Management Board

President of the Management Board	Piotr Woźniak	....
Vice President of the Management Board	Janusz Kowalski	....
Vice President of the Management Board	Łukasz Kroplewski	....
Vice President of the Management Board	Bogusław Marzec	....
Vice President of the Management Board	Maciej Woźniak	....
Vice President of the Management Board	Waldemar Wójcik	....

Warsaw, August 10th 2016