

## **THE REPORT OF THE SUPERVISORY BOARD OF PGE POLSKA GRUPA ENERGETYCZNA S.A. ON THE EVALUATION OF THE COMPANY'S POSITION IN THE YEAR 2011, INCLUDING AN EVALUATION OF THE COMPANY'S INTERNAL CONTROL SYSTEM AND RISK MANAGEMENT SYSTEM**

Since the first day of the Company shares' listing on the Warsaw Stock Exchange, i.e. since 6 November 2009, PGE Polska Grupa Energetyczna S.A. ("PGE S.A.", "PGE", "Company"), has been bound by the corporate governance principles specified in "The Good Practices of Companies Listed on the Warsaw Stock Exchange" adopted by a resolution of the Board of the Warsaw Stock Exchange in July 2007. At the stage of preparations for the Company's initial public offering the PGE Management Board adopted a resolution to follow the Good Practices.

Pursuant to chapter III item 1 sub-item 1) of the Good Practices, the PGE Supervisory Board submits a brief evaluation of the Company's position, including an evaluation of the internal control system and an evaluation of the risk management system. This evaluation has been prepared based on the documents submitted by the Management Board, discussions conducted with the members of the Management Board during the meetings of the Supervisory Board and discussions during the meetings of the permanent committees operating within the Supervisory Board, as well as the financial statements and the Management Board's report on the Company's activities.

### **I. AN EVALUATION OF THE COMPANY'S POSITION IN 2011**

**The Supervisory Board evaluates positively the position of PGE Polska Grupa Energetyczna S.A. in 2011.** The Company continued the process of building and strengthening its value as the dominant entity in the Capital Group of PGE Polska Grupa Energetyczna S.A. (PGE CG, "PGE Group", "Group")

The most important events of 2011 comprised the following:

- finalizing the sale of the shareholding in Polkomtel S.A.; as a result the generated funds will be used for financing the current and future investment projects of the PGE Capital Group,
- article 49a of the Energy Law introducing an obligation to sell electricity on a power exchange and (ii) changes in the structure of PGE CG after consolidation,
- the coordination of the work in the scope of the Efficiency Improvement Programme (EIP) in the PGE Capital Group,
- a continuation of work in the areas of nuclear power generation, including the creation of organisational, legal and administrative conditions for the construction of nuclear power plants in Poland,
- a continuation of work within the scope of "A Concept of Managing Non-core Assets within PGE CG",

In comparison to 2010, the Company recorded:

- a 3.6% increase in the balance sheet total to PLN 33,032.1 million,
- an 11.7% increase in equity to PLN 31,782.1 million,
- a 56.8% increase in net profit to PLN 4,556.1 million.

More information on the Company's activities in 2011 is presented below.

## **1. Basic information on PGE Polska Grupa Energetyczna S.A.**

### **1.1. Changes in the organisation and management of PGE S.A. and the PGE Capital Group**

During the period ended 31 December 2011 PGE S.A. did not stop any of its significant activities.

In 2011 there were no significant changes in the management principles of PGE S.A. and the PGE Capital Group. In 2011 two strategic projects were continued in the PGE Capital Group: the PGE Consolidation Programme and a project entitled "A Concept of Managing Non-core Assets within the PGE Capital Group". Additionally, in 2011 the operations in the area of nuclear power generation were continued.

#### **The Consolidation Programme**

The major changes in the organisation and management of PGE S.A. and PGE CG took place in the years 2009 – 2010, when the project called the Consolidation Programme was executed in the PGE Capital Group. As a result of the Consolidation Programme in 2010 there was a formal and legal merger of the entities in the following business areas: (i) mining and conventional power generation; (ii) renewable power generation; (iii) distribution; (iv) retail sales and the merger of the following companies: PGE Górnictwo i Energetyka S.A., PGE Energia S.A. and PGE Electra S.A. with PGE Polska Grupa Energetyczna S.A.

Work within the scope of the Consolidation Programme, including the building of an organisational structure and the identification of effectiveness and competitiveness improvement programmes are being continued.

In 2011 the Group finalised the sale of subsequent blocks of shares in companies which are not related to the power sector; such blocks of shares constitute parts of particular portfolios of assets earmarked for disposal. The group implemented further stages in the reorganisation of the activities related to hotel, security, transport, and medical services. The processes of the liquidation and bankruptcy of companies not related to power generation were finalised.

As a result of the continuation of the Consolidation Programme on 2 January 2012 there was a registration of the merger of such companies as Dychowskie Przedsiębiorstwo Eksploatacji Elektrowni „Eldeks” sp. z o.o. and Elektrownia Wiatrowa Kamieńsk [Kamieńsk Wind Farm] sp. z o.o. with PGE Energia Odnawialna S.A.

The merger of PGE Elektrownia Opole S.A. with PGE Górnictwo i Energetyka Konwencjonalna S.A. is in progress.

#### **A concept of managing non-core assets within the PGE Capital Group**

In 2011 the PGE Capital Group continued activities in the area of "A Concept of Managing Non-core Assets within PGE CG" whose objective is a transparent separation of the

Company's core business activity from other activities as well as a disposal and reorganisation of such non-core assets. Within the project in 2011 there were some transformations made in the area of hotels, security services and other services, inter alia there were

- mergers of such companies as PTS Betrans sp. z o.o. with its registered office in Rogowiec (the acquiring company) with Przedsiębiorstwo Transportowe ELTUR-TRANS sp. z o.o. with its registered office in Bogatynia (the company to be acquired);
- the merger of Elbest sp. z o.o. with its registered office in Rogowiec (the acquiring company) with BESTUR sp. z o.o. with its registered office in Bełchatów, PHU Global-Tur sp. z o.o. with its registered office in Bogatynia, Energetyk SPA sp. z o.o. with its registered office in Iwonicz-Zdrój, Centrum Szkolenia i Rekreacji Energetyk sp. z o.o. with its registered office in Krasnobród, Media-Serwis Dychów sp. z o.o. with its registered office in Dychów (the acquiring companies);
- the division of such companies as Elbest sp. z o.o. and PTS Betrans sp. z o.o.

Within the project in the years from 2009 to 2011 there were sold the shares in 29 companies, the liquidation process of 7 companies was completed, the insolvency proceedings were completed for 5 companies, there was a redemption of shares in 1 company, 9 holiday houses and 4 other assets were disposed of. The process started in 2009 of disposing the shares in the stock exchange listed company called Bank Ochrony Środowiska S.A. was continued.

## **1.2 Share capital and ownership structure**

As at the date of this report, the share capital of PGE S.A. equals PLN 18,697,837,270 and is divided into 1,869,783,727 shares with a par value of PLN 10.00 each.

The existing shares making up the Company's share capital have been issued and fully paid up. There are no preferred shares; all shares have the same rights incorporated in them, and in particular, each share gives the right to one vote at the General Meeting. All existing shares have been established pursuant to the relevant provisions of the Commercial Code, Commercial Companies Code and Company Statutes.

According to our knowledge, the only shareholder holding a significant block of shares is the State Treasury. In 2011 as at the day of holding the Ordinary General Meeting, the State Treasury had 69.29% share in the Company's share capital. As at the day of making the Financial Statements, after disposing by the State Treasury of 7.01% block of the Company's shares, its shareholding in the share capital decreased to 61.89%.

Although Company shares are not preferred, the Company Statutes provides for special rights for the State Treasury as long as it remains a shareholder.

## **2. Activities of the PGE Capital Group**

### **2.1. A description of the activities of the Capital Group**

PGE Polska Grupa Energetyczna S.A. the dominant entity in the Capital Group of PGE Polska Grupa Energetyczna S.A. The Group's business activities are currently organized in five segments:

- Conventional Power Generation (previously: Mining and Generation), which comprises the mining of lignite and generation of heat and electricity from conventional sources, as well as the transmission and distribution of heat,
- Renewable Power Generation, which comprises the generation of electricity from renewable sources and in pumped storage hydropower plants,
- Wholesale Trade in electricity and related products as well as fuels,

- Distribution of electricity,
- Retail sales of electricity.

The wholesale trade in electricity and related products is conducted directly in PGE S.A. It is the Company's core activity. Within the scope of the remaining activities, PGE S.A. provides so-called supporting services for the benefit of the companies belonging to the Capital Group, leases IT systems and rents office space.

In 2011 the Group's power producers sold electricity to PGE S.A. by means of regulated market and power exchanges (within the scope of the regulations of Article 49a clauses 1 and 2 of the Energy Law, i.e. the so-called "power exchange obligation") and to external customers. Energy purchased by PGE S.A. on regulated markets and stock exchanges as well as from external contractors was sold to the companies from the PGE Capital Group such as the Retail Sales and the Distribution Company, the contractors from beyond the PGE Group, on domestic or foreign market. The Retail Sales company from the PGE Capital Group made electricity purchases also from the local power generation sources located at the area where the company performs the role of the sales company ex officio.

In 2011 PGE Polska Grupa Energetyczna S.A. made purchases of hard coal for the needs of the power plants and CHPs from the PGE CG. The purchases were made from Kompania Węglowa S.A., Jastrzębska Spółka Węglowa S.A., Katowicki Holding Węglowy S.A., SUEK Polska sp. z o.o., PHU Energokrak sp. z o.o. and Carbo Proces Recykling sp. z o.o. Next, the coal was sold to particular generators from the PGE CG. Due to the current binding agreement with Kompania Węglowa S.A., the PGE CG is to a certain extent dependent on this supplier.

Apart from the above five major business lines, the PGE Group conducts activities also in other areas, including telecommunication. The Group comprises also other companies whose major business activities consists in providing auxiliary services to companies from the power and mining sectors. Such services comprise, among others:

- construction, repair and modernisation work as well as investment work related to power generation equipment,
- the performance of comprehensive diagnostic tests and measurements of power generation machines and equipment,
- the management of by-products of coal and lignite combustion, the development and implementation of technologies based on the utilisation of such products and the restoration of derelict industrial areas,
- medical and social welfare services.

## **2.2. Major domestic and foreign investments**

In 2011 PGE S.A. had investments classified as investments in financial instruments at the level of PLN 32,666.8 million in comparison to PLN 30,913.9 million in 2010.

PGE S.A. as the central entity of the PGE Capital Group, performs the role of an integrator ensuring for the PGE Capital Group entities on the one hand a source of financing, and on the other hand a possibility of their cash surplus allocation. PGE acquires the funds through own bond issue program directed to PGE Group companies, which have cash surpluses. Funds acquired in that way by PGE are intended in particular for purchase of bonds issued by the companies, which carry out investments.

In 2011 PGE S.A. held shares in its subsidiaries at the level of PLN 22,805 million.

In addition, as at 31 December 2011 the Company held funds invested in bonds of its 2 subsidiaries - PGE Górnictwo i Energetyka Konwencjonalna S.A. and PGE Energia

Odnawialna S.A. Bonds with a total nominal value of PLN 5,562 million were purchased by PGE S.A. under the following programs:

- The Agency agreement with ING Bank Śląski S.A. concluded on 13 September 2010 (agreement consolidated programs of the companies comprising PGE GiEK S.A., with ING Bank Śląski S.A. as Agent) allowing for issue of bonds of up to PLN 4,091 million. The maturity date of the agreement is 31 December 2013. As at 31 December 2011, the nominal value of the bonds acquired by PGE S.A. under this agreement amounted to PLN 3,129 million.
- The Agency agreement for the issue of bonds of up to PLN 3.700 million concluded on 30 November 2009 between PGE Elektrownia Bełchatów S.A. and PKO Bank Polski S.A. The maturity date is on 1 December 2014. As at 31 December 2011, the nominal value of the bonds acquired by PGE S.A. under this agreement amounted to PLN 2.153 million.
- The Agency agreement for the issue of bonds of up to PLN 500 million concluded on 20 June 2011 between PGE Energia Odnawialna S.A. and ING Bank Śląski S.A. The maturity date of the agreement is 31 December 2016. As at 31 December 2011, the nominal value of the bonds acquired by PGE S.A. under this agreement amounted to PLN 280 million. On 1 March 2012 the parties signed an Appendix no. 1 to the Agency Agreement, that changes the maximum amount of the programme to PLN 1.2 billion.

As at 31 December 2011 the balance sheet value of the issued bonds amounted to PLN 5,488 million.

### **Acquisition of shares in Energa S.A.**

On 29 September 2010 the Management Board of PGE S.A. entered with the State Treasury ("Seller") represented by the Minister of the State Treasury into an agreement for the sale of shares in Energa S.A. with the registered office in Gdańsk ("the Agreement"). The subject of the Agreement is the acquisition of 4,183,285,468 Energa S.A. shares, constituting 84.19% of the company's share capital for the price of PLN 7,529,913,000.

The Buyer (PGE) declares that the Energa Capital Group will undergo a programme of guaranteed investments worth PLN 5bn within the next 10 years. The failure of conducting the investments will result in contractual penalties paid to the Seller; however, the total liability of PGE S.A. must not exceed the amount of PLN 1 billion. Besides, PGE GiEK S.A. undertook to maintain the control over Energa S.A. It also undertook neither to limit both Energa's and its major subsidiaries' core businesses including power and heat generation, sales and distribution nor to move Energa's registered office. Besides, PGE GiEK S.A. undertook to introduce the shares of Energa S.A. to public trading on a regulated market, on Warsaw Stock Exchange.

The completion of the above mentioned transaction require PGE's obtaining a relevant acquisition permit from the President of the Office for Competition and Consumer Protection (condition precedent).

On 13 January 2011 the President of the Office for Competition and Consumer Protection issued a decision preventing PGE S.A. from the acquisition of Energa S.A. shares. („the Decision”).

In connection with this, on 18 January 2011 PGE S.A. concluded with the Seller an annex to the Agreement. Under this annex, the parties determined that the validity period of the Agreement would be 12 months from the date of its execution; the State Treasury and PGE S.A. decided to suspend the flow of term of the validity of the agreement until the time of the legally binding completion of the court proceedings concerning an appeal against the Decision.

On 28 January 2011 the Regional Court in Warsaw the Court for Competition and Consumer Protection, through the President of the Office for Competition and Consumer Protection, received an appeal of PGE S.A. against the Decision of the President of the Office for Competition and Consumer Protection preventing the concentration of PGE S.A. and Energa S.A. In its appeal, the Company motioned for a change of the Decision in whole and for a content related judgement through issuing a decision allowing the concentration of PGE and Energa S.A., or a possible annulment of the Decision.

According to the information held by PGE S.A., in the middle of February 2011 the President of the Office for Competition and Consumer Protection passed the Company's appeal to the Court of Competition and Consumer Protection in Warsaw, and thus, the President did not use his right for self-control of the Decision.

Until the date of this report, there was no verdict given by the Court of Competition and Consumer Protection in the case of PGE's appeal against the Decision. The date of the hearing was established for 14 May 2012.

### **2.3. Description of significant agreements**

Below we present agreements which, in the opinion of PGE S.A., are agreements entered into within the ordinary scope of business activities and are of significant importance for the Company's activities.

#### **2.3.1. Agreement for sales of electricity to PGE Obrót S.A.**

In 2011 PGE S.A. continued sales of electricity to PGE Obrót S.A. on the basis of framework agreement for sales of electricity concluded in 2007. The energy sold is intended for covering of the needs of end-users at PGE Obrót S.A. The sale is performed on the basis of transaction agreements covering the needs reported by PGE Obrót S.A. In 2011 the sales revenues under this agreement amounted to PLN 6,451.2 million, which represented 63.6% of sales revenues.

#### **2.3.2. Agreements with power generators within the PGE Group**

In 2010 PGE S.A. started to purchase electricity for the year 2011 on the basis of commercial agreements entered into with the producers belonging to the PGE Capital Group. In connection with the amendment to the Energy Law of 9 August 2010, which in article 49a regulates the sale of electricity by enterprises dealing with its generation (the so-called "exchange obligation"), all previous agreements between PGE S.A. and such producers were terminated.

Simultaneously, with respect to electricity not covered by this obligation, an agreement was entered into with PGE Górnictwo i Energetyka Konwencyjna S.A. This is an agreement for an indefinite period of time. Under this agreement, electricity is purchased on the basis of transaction arrangements.

#### **2.3.3. Agreements for the delivery of hard coal**

Due to the execution of the Energy Law amendment effective from 9 August 2010, which regulates - through article 49a - the mode of electricity sales by the generators (so called "power exchange obligation"), in 2011 there was effective the Agreement concluded by PGE S.A. with PGE Górnictwo i Energetyka Konwencyjna S.A. for the purchase of the electricity not covered by the above mentioned obligation (Framework Agreement No. 1/PGE/GiEKSA/2010 regulating the purchases from the PGE Capital Group's CHPs). This is an agreement for an indefinite period of time. Under this agreement, electricity is purchased on the basis of transaction arrangements.

Sale of electricity generated by power plants from PGE Górnictwo i Energetyka Konwencjonalna S.A. and by PGE Elektrownia Opole S.A. was conducted on the organised markets pursuant to art. 49a of the Energy Law.

Additionally, the purchase of electricity was conducted on the basis of EFET agreements between PGE S.A. and PGE Górnictwo i Energetyka Konwencjonalna S.A. and PGE Elektrownia Opole S.A.

#### **2.3.4. Agreements for the delivery of hard coal**

2011 was another year of centralised purchases of power coal for the power plants and cogeneration plants belonging to PGE CG. In 2011 these plants were supplied with coal by PGE Polska Grupa Energetyczna S.A. on the basis of agreements entered into mainly with domestic producers of coal. Yearly agreements for purchase and resale were in period from December 2010 till February 2011. In December 2010 PGE S.A. signed an agreement with Kompania Węglowa S.A. for the delivery of coal in the years 2011-2013 with the estimated value of about PLN 3.9 billion. During the course of the year 2011 the volume of purchased coal was supplemented with spot agreements or relevant annexes to the purchase agreements. In the fourth quarter of 2011 the imported coal was purchased from the following companies: Jastrzębska Spółka Węglowa S.A., SUEK Polska sp. z o.o. and PHU Energokrak sp. z o.o.

#### **2.3.5. PGE Polska Grupa Energetyczna S.A. Initiates a Bond Issue Programme**

On 29 August 2011 the Company concluded an agreement for indefinite period with Bank Polska Kasa Opieki S.A. (acting as Agent, Paying Agent and Depository) and ING Bank Śląski S.A. (acting as Sub-Agent, Paying Sub-Agent and Sub-Depository). The bond issue program (the "Programme") was established on the ground of the above agreement.

The maximum indebtedness amount from the bonds issued (representing a maximum aggregate nominal value of bonds issued and outstanding) under the Programme cannot exceed PLN 5 billion.

Under the Programme, the company is entitled to issue bearer bonds ("Bonds") in dematerialized form in accordance with the Act on Bonds dated June 29, 1995 (Journal of Laws of 1995 No. 83, item 420 as amended) (the "Act on Bonds") with projected maturity – depending on the type of Bonds – for zero-coupon Bonds not longer than 1 year, and for coupon Bonds not shorter than 1 year and not longer than 10 years, according to the terms of issue of the given Bonds series. The Bonds will be issued pursuant to Article 9, section 3 of the Act on Bonds and the issues will be non-public. The Bonds may be dematerialized at the National Depository for Securities and quoted on the Alternative Trading System ("ASO") organized by the Warsaw Bonds. Under the Programme will be denominated in Polish zlotys (PLN) and the nominal value of one bond will amount to PLN 10,000 or multiple of that amount.

Bonds under the Programme may be denominated in Polish zlotys (PLN) and the nominal value of one bond will amount to PLN 10,000 or multiple of that amount. The price terms of the Bonds – discount for zero-coupon bonds and interest rate/coupon for the coupon bonds – are determined during the Bonds offering. The bondholders are only entitled to the benefits of monetary nature.

#### **2.3.6. Sale of 100% of Polkomtel S.A. shares to Spartan Capital Holdings sp. z o.o.**

On October 24, 2011 Polish Office of Competition and Consumer Protection approved the transaction of sale of 100% of Polkomtel shares to Spartan Capital Holdings Sp. z o.o.

Consequently, a condition of the preliminary agreement signed on 30 June 2011 between PGE, PKN ORLEN S.A., KGHM Polska Miedz S.A., Vodafone Americas Inc, Vodafone International Holdings B.V. and Weglokoks S.A. as the sellers ("Sellers"), and Spartan Capital Holdings Sp. z o.o., the special purpose vehicle controlled by Mr. Zygmunt Solorz-Żak, as the purchaser ("Purchaser") for the sale of 100% of shares in Polkomtel S.A. (the "Agreement"), has been fulfilled (information on the Agreement was provided by the Company in the regulatory announcement no 29/2011 dated 30 June 2011).

The transfer of the shares and payment for the shares were completed on 9 November 2011. After taking the income tax into account, PGE achieved a profit from the sale transaction in amount of PLN 1.32 billion, recognised in November 2011.

Following the completion of the transaction and acquisition of 100% shares in Polkomtel S.A. by Spartan Capital Holdings Sp. z o.o. PGE S.A. holds no shares in Polkomtel S.A.

## **2.4. Major achievements in research and development**

In 2011 PGE S.A. continued its operations in the area of nuclear power generation. PGE S.A. prepared an analysis of the best solutions (organizational, financial legal and corporate solutions) concerning the management and execution of nuclear power plant construction projects.

The first stage of works, i.e. "Search and assessment of localization – determination of 3 localisations for environmental and site characterization" was completed in November 2011. The information on three localization chosen for further research was published (alphabetically):

- Choczewo (Choczewo Commune, Wejherowski District, Pomorskie Province)
- Gąski (Mielno Commune, Koszaliński District, Zachodniopomorskie Province)
- Żarnowiec (Krokowa Commune, Pucki District, Pomorskie Province).

The necessary legal actions have been taken in order to begin environmental and site characterisation for the above localisations.

Simultaneously, as a part of communication campaign, in December 2011 the representatives of PGE Energia Jądrowa S.A. and PGE EJ1 sp z o.o. ("PGE EJ1") participated in meetings with the representatives of the local authorities and communities in area of Mielno, Choczewa and Krokowa municipalities.

Within the scope of activities related to the selection of technology, in the fourth quarter of 2011 the company continued work on the preparation of tendering procedure documentation related to the selection of a technology provider and a main EPC contractor.

In 2011 PGE EJ S.A. and PGE EJ 1 sp. z o.o. participated in public and inter-ministerial consultations of drafts of implementing decrees to the Nuclear Act. It is expected that first drafts of key decrees will be approved by the Ministerial Council Committee in 2012.

The works on preparation of the text of the cooperation agreement with the Internal Security Agency (ABW) with regard to safety issues were conducted in the second half of 2011. The proper agreement was signed in October 2011. Moreover, the works on preparation of terms of reference in the scope of integrated architecture of the information safety management, including certification according to ISO 27001 and business continuity procedures.

The studies in the scientific-industrial consortium "Carbon Fuel Cells" were continued in 2011.



The purpose of the consortium is construction and demonstration of work of a carbon fuel cell in size allowing for accomplishment of technical and economic analysis of the undertaking and determining the implementation potential.

The works were divided into three stages. First stage, completed in February 2012, was concentrated on calculations and laboratory research of small cells. The second stage assumes the optimization of performance of small cells. The third stage assumes construction and testing of repeatable packets intended for use in complete cell and determination of the commercial potential of the technology.

The studies in the Polish Platform of Clean Coal Technologies ("PPCCT") were also continued in 2011. PPCCT is an initiative by the energy sector companies for the clean coal technologies.

In 2011, the PGE initiated and began preparatory works with regard to the following projects:

- elaboration of possibilities of co-combustion of raw and dried lignite in selected PGE CG power plants; project in cooperation with PGE GiEK S.A.;
- study works on „Enriched hard coal as a significant factor of balanced development and guarantor of efficiency improvement of Polish power industry” – joint initiative project of power companies coordinated by the Polish Power Plants Economic Society;
- initiated in cooperation with PGE Dystrybucja S.A. project of construction of prototype allowing for compensation of brief decays of voltage in energy grid with energy repository in form of HV supercondensators battery;
- elaboration of concept, and ultimately creation of training system for operators on the base of simulators of units work and of e-learning system – initiated in cooperation with generators from PGE GiEK S.A.

### **Cooperation with international organisations**

PGE S.A. actively cooperates with international organisations. PGE S.A. along with the Companies of the Group cooperates through the Polish Electricity Committee (PEC) with the Union of the Electricity Industry EURELECTRIC. PGE S.A. is a member of the Baltic Ring Committee for Cooperation in the Area of Electricity BALTREL. Participation in BALTREL committee gives possibilities to influence the concept of the electro energy market in that part of Europe. PGE participates in the studies of ETP ZEP (European Technology Platform For Zero Emission Fossil Fuel Power Plants Advisory Council). ETP ZEP was created in order to allow the European power plants fired by solid fuels reaching CO<sub>2</sub> emission of zero.

CO<sub>2</sub> EuroPipe project, started in 2009, has been completed in 2011. PGE S.A. participated in the project together with more than 15 companies from different EU countries.

The project execution resulted in preparation of a report on all aspects (technical, financial and organisational) of CO<sub>2</sub> transportation- from CO<sub>2</sub> capture through pipe transport to the storage locations till the storage related problems.

### 3. The economic and financial position

#### 3.1. The financial results achieved by PGE S.A.

(in thousand PLN)	Period 1-12 2011	Period 1-12 2010	% change
Sales revenues	10.137.893,2	11.663.346,3	-13,1%
Cost of own sales	9.784.114,6	11.324.805,9	-13,6%
<b>Gross sales result</b>	<b>353.778,6</b>	<b>338.540,4</b>	<b>4,5%</b>
<b>% of income from total sales</b>	<b>3,5%</b>	<b>2,9%</b>	
Selling expenses and General and administrative expenses	139.722,6	127.619,8	9,5%
<b>Profit on sales</b>	<b>214.056,0</b>	<b>210.920,6</b>	<b>1,5%</b>
Other operating revenue	5.637,3	12.747,5	-55,8%
Other operating expenses	40.851,5	16.030,9	154,8%
<b>EBIT</b>	<b>178.841,8</b>	<b>207.637,2</b>	<b>-13,9%</b>
<b>% of income from total sales</b>	<b>1,8%</b>	<b>1,8%</b>	
Finance income	4.889.376,0	2.874.333,8	70,1%
Finance costs	105.359,1	91.869,1	14,7%
<b>Gross profit</b>	<b>4.962.858,7</b>	<b>2.990.101,8</b>	<b>66,0%</b>
<b>% of income from total sales</b>	<b>49,0%</b>	<b>25,6%</b>	
Income tax expense	406.743,2	85.223,6	377,3%
<b>Net profit</b>	<b>4.556.115,5</b>	<b>2.904.878,3</b>	<b>56,8%</b>
<b>% of income from total sales</b>	<b>44,9%</b>	<b>24,9%</b>	
<b>EBITDA</b>	<b>202.257,1</b>	<b>236.571,9</b>	<b>-14,5%</b>
<b>% of income from total sales</b>	<b>2,0%</b>	<b>2,0%</b>	

PGE's net profit reached the level of PLN 4,556.1 million in the financial year ended 31 December 2011, which is a 56.8% increase over the results of the financial year ended 31 December 2010.

The Company's net profit margin (the ratio of net profit to total sales revenues) equalled 44.9%. The growth of net result was gained mainly due to a better result on financial activities, in particular it was because of the growth from the sale of investment by PLN 1,630.2 million (the sale of the shares in Polkomtel S.A. generated the highest revenue).

In 2011 PGE S.A. recognised total revenues in amount of PLN 15,032.9 million, which means a growth by 3 % compared to 2010.

The decrease of revenues from sales of finished goods and merchandise by more than 14% compared to 2010 mainly resulted from drop in revenues from electricity sales

The decrease in revenues from the sales of electricity by PLN 2,547.4 million, resulted from lower volume of electricity sold by 16.1 TWh, what was caused by the change of electricity trading model in PGE Group as a result of introduction of so called power exchange obligation. The decreased volume of sales was partly compensated by the higher average sale price (by PLN 12.8 PLN/MWh). The average sale price of electricity amounted to PLN 201.7 PLN/MWh in 2011.

Sales of goods in 2011 included mainly: (i) sales of property rights (certificates of origin of electricity) and (ii) trading of CO<sub>2</sub>, allowances that was executed in 2 segments: for the needs of generators from PGE Group and for the needs of the external contractors. Growth

of revenues in that category in 2011 resulted from increased sales of CO2 allowances to the generators from the Group and increased sales of property rights to PGE Obrót S.A.

Sales of services in 2011 mainly included: (i) management of sales of electricity for the generators from PGE Group, (ii) transit trading of hard coal, (iii) rendering of OHT services for the PGE Group companies and external contractors and (iv) services of the Balancing Group. Growth of revenues in that category in 2011 resulted mainly from increased sales of services related to management of sales of electricity for the generators from PGE Group in amount of PLN 146.3 million in 2011 (growth by PLN 144.6 million).

Within other operations of PGE, the slight decrease in revenues was recorded. The decrease related mainly to lease of IT systems, while revenues from rendering of support services for the companies from the PGE Group and from rentals increased. The support agreements have been in effect since January 2008 and were signed following the "Agreement concerning the principles for the cooperation of PGE S.A. with PGE Capital Group Companies", that is, the document specifying the principles and scope of the cooperation of Group Companies in order to build a highly effective organisation implementing the strategy of Polska Grupa Energetyczna.

Revenues from other operations in 2011 decreased mainly as a result of lack of revenues from the revaluation of provision for the claims of foreign contractor (Alpiq Holding AG) relating to expenses for reservation of interconnectors capacities (decrease by PLN 11.5 million) and realisation of higher profit on sales of fixed assets (growth by PLN 3.4 million).

Increase of financial revenues is mainly connected with higher profit from disposal of investments (by PLN 1,630.2 million) resulting from sale of shares in Polkomtel S.A. (profit on sales in amount of PLN 1,630.0 million), higher revenues from dividends (growth by PLN 312.7 million) and higher revenues from the bonds possessed, which were issued by the Group companies (growth by PLN 68.6 million).

In 2011 and 2010 PGE obtained revenues mainly from electricity sales on domestic market. During 2011, the Company pursued export electricity sales through its subsidiary Electra Deutschland GmbH. In 2011 export sales amounted to PLN 120.3 million.

Cost of goods sold in 2011 amounted to PLN 9,784.1 million, which means a decrease by 13.6% compared to 2010. The decrease of cost of goods sold was affected by lower costs of electricity purchases by PLN 2,334.4 million as compared to 2010 (decrease by 23.2%). With the average electricity purchase price higher by PLN 15.91/MWh as compared to the previous year, the lower cost of electricity purchases resulted from lower volume of the electricity purchased by 16.1 TWh, caused by the change of electricity trading model in PGE Group as a result of introduction of so called power exchange obligation. Higher electricity purchase price in 2011 is a result of higher market prices.

In 2011 total selling expenses of PGE S.A. amounted to PLN 17.4 million, i.e. were lower by PLN 3.5 million as compared to the previous year.

The general and administrative expenses of PGE S.A. in 2011 amounted to PLN 122.4 million and were higher by PLN 15.6 million compared with the previous year. The growth of the general and administrative expenses by PLN 13 million was mainly caused by the change of allocation of expenses relating to the marketing, sponsoring, IT services and depreciation, in connection with the merger of PGE S.A. with PGE Electra S.A. Additionally, the general and administrative expenses was also affected by higher advisory expenses (by more than PLN 3.0 million) mainly relating to Non-core Assets Restructuring Program and creation of Shared Services Centre.

The growth of other operating expenses in 2011 by PLN 24.8 million was caused by increase of expensed regarding the provision for disputes with a foreign contractor as a result of realisation of commercial agreements (by PLN 36.1 million) due to change of

EUR/PLN exchange rate. Moreover, the increase of expenses was partly compensated by decrease in expenses relating to provision for contractor claims on transmission services by PLN 10.3 million.

The increase of financial expenses by PLN 13.5 million was mainly caused by higher costs of the issued bonds by PLN 33.7 million, higher expenses with regard to increased provision for interest form claims for the foreign contractor relating to cost of reservation of interconnectors capacities (by PLN 12.6 million). In addition, the increased expenses were partly compensated by lower expenses due to write-offs on receivables by PLN 27.1 million.

### **3.2. The Company's asset position**

Assets of PGE S.A. as at 31 December 2011 and as at 31 December 2010 amounted to PLN 33,032.1 million and PLN 31,887.07 million, respectively. The growth of assets mainly resulted from: (i) increase of deposits and cash by PLN 2,863.9 million, (ii) decrease of available-for-sale financial assets, mainly connected with the sale of Polkomtel, by PLN (-) 1,654.1 million.

Bonds purchased as at the end of 2011 as compared to the end of 2010 grew by PLN 610.6 million. The Company had bonds issued by PGE GiEK SA, PGE Energia Odnawialna S.A., Autostrada Wielkopolska S.A.

As at December 31, 2011 and as at December 31, 2010 the total equity of PGE S.A. amounted to PLN 31,782.1 million and PLN 28,441.5 million, respectively, which constitutes 96.2% and 89.2% of the total equity and liabilities, respectively. The increase of retained earnings by PLN 1,514.8 million and increase of reserve capital by PLN 1,825.6 million contributed to the increase of total equity.

Short-term liabilities decreased by PLN 2,193.6 million as compared to the previous year, in connection with decrease - by PLN 2,011.1 million of liabilities related to the interest bearing bank loans and credits and debt securities and with decrease of trade liabilities by PLN 549.5 million.

### **3.3. Statement of cash flows**

Cash and cash equivalents as at December 31, 2011 amounted to PLN 1,018.2 million and were higher by PLN 759.8 million than at the end of the corresponding period of 2010.

Total net cash flows from operating activities for the 12-month period ended December 31, 2011 amounted to PLN (-) 50.9 million as compared to PLN 324.0 million for the 12-month period ended December 31, 2010.

The growth of gross profit from continued operations in the 12-month period ended December 31, 2011 by PLN 1,972.7 million as compared to the 12-month period ended December 31, 2010, mostly resulted from profit achieved on sale of Polkomtel and higher amount of dividends received. The negative cash flows from operating activities were mainly caused by repayment of Company's liabilities higher by more than PLN 374 million as compared to the previous year.

Positive net cash flow from investing activities for the reporting period ended December 31, 2011 amounted to PLN 4,120.2 million versus PLN (-) 3,547.2 million in 2010.

The balance of cash flow from investing activities for the 12-month period of 2011 consisted mainly of dividends received in amount of PLN 3,386.9 million and cash flow relating to sale and purchase of financial assets in amount of PLN (+) 498.2 million.

Net cash flow from financial activities in 2011 amounted to PLN (-) 3,309.4 million, versus PLN 79.9 million of net cash flow from financial activities in 2010.

The above result for 2011 was affected mainly by repayment of current account credits incurred in 2010 in amount of PLN (-) 229.8 million, dividend payment in amount of PLN (-) 1,217.7 million and buyout of bonds issued by PGE in 2010 in amount of PLN (-) 1,781.3 million.

<b>3.4. Financial ratios</b>	Period 1-12 2011	Period 1-12 2010
<b>Return on sales ROS (%)</b>		
Net profit x 100% / net sales revenues	<b>44,9%</b>	<b>24,9%</b>
<b>Return on equity ROE (%)</b>		
Net profit x 100% / (equity - net profit)	<b>16,7%</b>	<b>11,4%</b>
<b>Debt ratio (w %)</b>		
Liabilities x 100% / total equity and liabilities	<b>3, 8%</b>	<b>10,8%</b>
<b>Current ratio</b>		
current assets / current liabilities	<b>4,3</b>	<b>2,5</b>

### **3.5. Financial resources management and financial liquidity**

As at the end of the year 2011 the Company had a considerable financial surpluses. In 2011 PGE S.A. generated funds from the sale of financial assets, from the dividends received from its subsidiaries and from issuing bonds. The funds generated in such a way were spent by PGE S.A. on financing investment projects and refinancing credits in the companies from the Group by purchasing bonds issued by these companies. They were also used for streamlining its ownership structure and for 2010 dividend payouts to its shareholders.

Table: Indebtedness

(in thousand PLN)	Period 1-12 2011	Period 1-12 2010	% change
Bank credits	-	229.805,2	-
Debt securities	-	1.781.326,4	-
Indebtedness	-	2.011.131,6	-
Cash and cash equivalents	1.020.822,9	257.955,4	295,7%

Cash and cash equivalents held by PGE S.A. and by the companies from the Group as well as the open credit limits ensure sufficient funds for financing the Company's current operations.

#### **4. Important factors for the development of PGE S.A. and PGE Capital Group**

According to the expectations, the factors listed below will exert an influence upon the resulted of the Company and the Group in the perspective of at least year 2012:

- the volume of the demand for electricity and heat;
- the prices of electricity on the wholesale market;
- the prices of property rights resulting from renewable energy certificates;
- the availability and the prices of the fuels used for electricity and heat production, in particular the prices of hard coal, natural gas and heating oil;
- the availability and the prices of CO<sub>2</sub>emission allowances;
- the availability of trans-boarder transmission capacities,
- the tariff process for 2013, including in particular costs recognised by the President of the Energy Regulatory Office as reasonable and the amount of reasonable return on equity, as well as tariff approval date;
- the decisions of the President of the Energy Regulatory Office within the execution of the Long-term Power Purchase Agreements;
- amendments to the Energy Law and others acts;
- court's ruling on the disputes between the President of the Energy Regulatory Office and generators from the PGE Group entitled to receive compensations under PPA Act with regard to the annual adjustments of the stranded costs for 2008 and annual adjustments of the stranded costs and annual adjustments of costs generated in gas-fuelled units for 2009 and 2010;
- possible different decision in law, tax and other contingent liabilities disputes, presented in Note 30 to the financial statements;
- verdict of the Court of Competition and Consumer Protection in case of PGE's appeal against the decision on the President of the Office of the Competition and Consumer Protection with regard to the purchase of shares of ENERGA S.A.;
- planned sale of Exatel S.A. shares;
- changes in the macroeconomic environment of the Group particularly in interest rates and currency exchange rates whose value influences the evaluation of assets and liabilities disclosed by the Group.

#### **5. Risks and threats to PGE S.A. and the PGE Capital Group**

The business activities of PGE and other major companies belonging to the PGE Capital Group, for which PGE is the parent company, similarly to the activities of other entities operating in the power generation sector, are exposed to a number of risks and threats, both external ones related to the market, legal or regulatory environments and internal ones related to the conduct of business operation

The most important risks and threats to which the Company and PGE CG are exposed include the following:

- the risk related to the macroeconomic situation in Poland and abroad,
- the risk of intensifying competition (the freedom of choosing an electricity provider),
- the risk of lower demand for electricity and heat,
- the political risk,

- the risk of changes in the law and other regulations concerning the Company's activities, as well as changes in their interpretation and application,
- the risk connected with the planned Renewable Sources of Energy Law,
- the risk related to the requirement to hold a licence,
- the risk connected with a potential breach of anti-monopoly regulations,
- the risk related to the regulations imposing a duty of ensuring the sufficient number of the certificates of origin,
- the risk related to the CO2 emission reduction programme,
- the risk of limitations in the emission of substances other than CO2 and more stringent BAT standards,
- the risk of interruptions in the delivery of fuels to our power plants, cogeneration plants and heat plants,
- the risk related to the atmospheric factors,
- the risk related to the provision of financing services,
- the risk of lowering or withdrawing the PGE's rating,
- the risk related to the decisions of the President of the Energy Regulatory Office within the execution of the Long-term Power Purchase Agreements Law,
- the risk of transfer prices,
- the risk related to court, arbitration and administrative proceedings,

## **II. AN EVALUATION OF THE INTERNAL CONTROL SYSTEM AND AN EVALUATION OF THE RISK MANAGEMENT SYSTEM**

PGE operates an internal control system as well as a risk management system. These systems comprise all solutions developed and implemented by the Company's management and employees with a view to achieving a reasonable assurance that the Company's and particular organisational units' business objectives are being achieved. It is the Management Board that is responsible for the establishment of these systems as well as their development, functioning and respective strategies.

The key elements of PGE's internal control and risk management systems include the following:

- a) the Company's internal processes, both automatic and manual control mechanisms limiting the level of risks related to the achievement of business objectives,
- b) the formalised risk management process allowing the Company the orderly and comprehensive - on the basis of the methodology common for the whole Group - identification, measurement and current management of financial and non-financial risks occurring during the course of business operations. Risk management is to provide information on threats to the achievement of business objectives and to limit the negative consequences of such threats; this should support the fulfilment of the strategic objectives, the current operations, the achievement of planned and adopted financial objectives as well as to ensure the conduct of activities in accordance with the law and the formal internal regulations. Risk management allows PGE to take preventive or corrective action in response to threats to the fulfilment of business objectives. Risk management is a central function which, nevertheless, covers the whole Group and is supported by all companies belonging to the Group. PGE's central risk management team determines the methodology of risk management and is responsible for its implementation. The major objective of the team's activities is to generate up-to-date and reliable knowledge of threats to PGE CG's operation and to contribute to the limitation of such threats' potential consequences. In order to ensure the achievement of this objective, PGE, in cooperation with the companies belonging to PGE CG, is responsible in particular for the execution of the following tasks:

- the identification of risks and preparation of registers of risks for the particular business segments,
- the measurement and quantification of risks as well as the preparation of risk maps for the particular business segments,
- the development of risk management models for the particular business segments; risk analysis, including the determination of risk management strategies, methods and tools,
- the monitoring and reporting of risk management results.

The so-called risk owners (the companies belonging to the Group, PGE's organisational units) are responsible for current risk management, in accordance with the determined methodology.

- c) the internal audit whose objective is carry out an independent and objective evaluation of the internal control and risk management systems. PGE's internal audit functions on the basis of the internal audit regulations developed in accordance with the international standards of professional internal audit practices. Audits comprise planned and summary audit tasks both in the parent company and the Group's other companies. Audit plans are developed based on risk analyses. Audit results are reported to the PGE Management Board. Recommendations resulting from conducted audits are successively implemented by the responsible entities (the Group's companies, PGE's organisational units), and their implementation status is monitored periodically.
- d) the dedicated function of investigative control focusing on the identification of malfeasances and the conduct of evidence and protective proceedings in PGE and PGE CG; it develops also the systems monitoring the Group's activities with respect to the identification of potential cases of infringing on business security.
- e) the controlling function; in its scope, periodic managerial reports are evaluated with respect to the rationality of information included in them, in particular within the context of analysing deviations from the assumptions adopted in financial plans.

In particular, the following internal control and risk management tools are used in the process of drawing up the Company's financial statements: internal procedures regulating the process, the mechanisms of managing IT systems used in financial information recording and reporting as well as their protective mechanisms, the principles of supervision over the preparation of financial statements, the principles of the verification and evaluation of financial statements, internal audits and corporate risk management as well as other elements of control. An independent evaluation of the reliability and correctness of the financial statements prepared by PGE and the companies subject to the process of consolidation is carried out by certified auditors. Two firms have been selected to audit the 2011 financial statements prepared in the key companies of the PGE Capital Group. They will be responsible for the review of half-annual financial statements as well as the preliminary and major audit of the financial statements. PGE CG operates a multi-stage process of approving financial statements, including also the participation of the Supervisory Boards. It is the Supervisory Board that evaluates the separate and consolidated financial statements of PGE. The separate financial statements of the companies subject to the process of consolidation are evaluated by their respective Supervisory Boards. The financial statements are approved by the General Meetings of the particular companies.

According to the Company Statutes, the Supervisory Board exercises permanent supervision over the Company's operations in all areas of activity.

Once a year the Supervisory Board adopts its own plan of work taking into consideration the necessity of the Board's becoming familiar with important materials describing the Company's financial position and providing information on possible risks.



The Supervisory Board supervises the Company's internal control system mainly through its Audit Committee. The major objective of the Audit Committee is providing the Supervisory Board with recommendations and opinions concerning matters belonging to its scope of operation, i.e. the examination of the correctness and effectiveness of conducting internal financial inspections in the Company and PGE CG and cooperation with the Company's auditors.

**The Supervisory Board evaluates positively the internal control system as well as the risk management used in PGE Polska Grupa Energetyczna S.A. in the year 2011.**

Chairperson of the Supervisory Board  
PGE Polska Grupa Energetyczna S.A.

Marcin Zieliński

Vice Chairperson of the Supervisory Board

Mr Maciej Bałtowski .....

Members of the Supervisory Board:

Mr Jacek Barylski  
.....

Ms Małgorzata Dec.....

Mr Czesław Grzesiak  
.....

Mr Grzegorz Krystek  
.....

Ms Katarzyna Prus  
.....

Mr Zbigniew Szmuniowski  
.....

Mr Krzysztof Żuk  
.....