Letter from the President of the Management Board

Ladies and Gentlemen,

In the year 2006, the Management of the Polish Oil and Gas Company moved a number of strategic projects to the implementation phase with a view to ensuring safe and secure gas supply for the customers of the PGNiG Group and continued growth and modernisation of the company. The efforts were mainly focused on the development of the exploration and production activity, expansion of the underground gas storage capacity and projects supporting diversification of gas supply sources and directions. We also embarked on the unbundling of the trading function and the technical distribution of gas in accordance with the requirements of the European gas directive taking effect as of 1 July 2007, which entailed changes in the organisational structure of the PGNiG Group.

We intend to prepare the company for operation in a liberalised, European gas market and build a recognisable and reliable brand. Our goal is to strengthen the position of the PGNiG Group as a leading gas company in Central and Eastern Europe, that is fully capable of facing the competitive challenge.

Financial Condition

The year 2006 brought about a major improvement in the financial performance of the PGNiG Group. The revenue from sales totalled PLN 15.2 billion with net profit reaching PLN 1.3 billion, which represents an increase by 50% as compared to the year 2005. These results put the Group among the most profitable companies in Poland. In 2006, the company achieved a net profitability of 8.7%.

In the financial markets the company has earned the reputation of a stable player that strives for performance improvement at every level of the income statement. On 5 February 2007, Standard&Poor's upgraded the rating of PGNiG to "BBB+". In the rationale for its decision, the agency underlined the positive outlook for further value growth of the company and the improved financial liquidity of PGNiG. Specifically, the agency noted the good profit growth prospects for PGNiG in the exploration and production business and the increasing role of domestic production in the satisfaction of the growing demand for natural gas in Poland.

Diversification of Supply Sources and Directions

The projects undertaken by the company with a view to ensuring secure, uninterrupted gas supply have a long-term character and involve a major capital commitment. In addition to securing supplies under long-term contracts, in 2006 we developed relationships with a number of suppliers active in different areas of origination of the gas volumes distributed by the PGNiG Group. Building on a diversified supplier portfolio, the PGNiG Group is well positioned for successful international growth. The strategic significance of this policy was confirmed by the decisions on the construction of a receiving terminal for liquefied natural gas and the acquisition of fields in the Norwegian Continental Shelf.

The key project in this area, launched in 2006, concerned the preparation of the Feasibility Study and Technical and Economic Assumptions for LNG Imports to Poland. On 15 December 2006, on the basis of its results and taking into account a range of technical and economic criteria, the Management Board decided on the location of the LNG regasification terminal in Świnoujście. Currently, the Company is preparing for the commencement of the construction phase. Initially, in 2011, the terminal will have the throughput capacity of 2.5 billion cu. m of gas per annum. With this innovative project, Poland will enter the worldwide LNG market and achieve greater flexibility of gas purchases while reducing its dependency on gas imports from a single direction.

In the year 2006, the company was also working towards establishing a connection with hydrocarbon fields in the North Sea. Talks with the Scandinavian counterparts were resumed regarding the development of the necessary infrastructure. At the same time, in the second half of last year, the Management Board of PGNiG started negotiations aimed at the acquisition of 15% interest in the exploration and production licences in the Skarv and Snadd fields in the Norwegian Continental Shelf from Mobil Development Norway A/S and ExxonMobil Production Norway Inc. The relevant conditional agreement was signed on 28 February 2007. The first oil and gas production from these fields is expected in mid 2011. The acquisition of interests in licence blocks in the Norwegian Sea opens up new businesses opportunities for the PGNiG Group and will enable its active participation in the international gas market. This also means the possibility of gaining new, valuable experience in offshore exploration and production well drilling in cooperation with such international companies as Shell, Statoil, Norsk Hydro or BP.

Development of Trading Activity

In 2006, the PGNiG Group sold 13.7 bcm of gas and 515 thousand tons of crude oil. The domestic consumption needs were fully secured owing to new long-term contracts concluded

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on 17 August 2006 with VNG AG (annual gas supply volume ranging from 400 to 500 million m^3 until 2016) and on 17 November 2006 concluded with RosUkrEnergo AG (for purchase of 2.5 billion m^3 of gas per annum, until 2009, with an option of extension for further two years).

In accordance with the prescriptions of Directive 2003/55/EC of the European Parliament and the Council and the amended Energy Law, the company started preparations for legal unbundling of the trading activity from the technical distribution of gas by 1 July 2007. As part of this process, Distribution System Operators will be spun off from the existing gas distribution companies. All wholesale and retail activities will be integrated in a newly established Trading Branch of PGNiG. The integration of the trading function in PGNiG will lead to the creation of a focused gas sales unit and implementation of new service standards aligned to the needs of individual customer segments. PGNiG is attaching great importance to strengthening its customer relations to make sure that the value proposition of PGNiG remains attractive for them and meets the requirements of a liberalised market after 1 July 2007.

However, full utilisation of the economic potential of the PGNiG Group in its core business depends on the revenues from gas sales, which are determined by the tariff regulations of the Chairman of the Energy Regulatory Authority. In this area, the key threat for efficient operation of the company stems from the fact that the real costs of gas imports and the necessary investments in storage capacity development are not fully reflected in the regulated tariffs. At the moment, the Group has limited options with respect to treating the domestic gas fields as its strategic reserve, and at the same time is not in the position to implement further investments in the exploration and exploitation of these reserves on fully satisfactory terms. The Management of PGNiG has been consistently advocating a tariff policy which would include all the pricing elements that are justifiable in terms of both the economic reality and the national energy security considerations.

Storage Capacity Expansion

The PGNiG Group currently operates seven underground gas storage facilities and is implementing a programme to increase their capacity up to 2.8 bcm by 2012, so that it corresponds to approx. 17% of the domestic gas consumption. The investments into storage infrastructure are a strategic decision of the PGNiG Group, which was driven not only by the new requirements of the act on stocks of crude oil, petroleum products and natural gas, which came in force in 2007, but is also seen as a step towards preparing the Company for the competitive game in the European gas market.

In 2006, the Company started the development of two new caverns in the Mogilno UGS was started and the preparations of further investment projects were underway, including the expansion of the UGS facilities in Wierzchowice and Strachocina. The expected capital expenditures for these purposes will total approx. PLN 1.4 bn.

Development of Exploration and Production Activity

The geophysical and drilling companies of the PGNiG Group carried out exploration in the Carpathians, the Carpathian Foredeep and the Polish Lowlands. The domestic reserves are estimated at 102.5 bcm of natural gas and 21.4 million tons of crude oil. As a result of these efforts, the volume of reserves in documented fields to the yearly production of the PGNiG Group, measured by the R/P ratio, is pegged at 26 years, which is a very good result comparing to such European gas companies as Shell, ExxonMobil, BP, Total or Gazprom. Also, the Reserves Replacement Ratio achieved by the Group stands at a very good level of 1.4, which means that the discoveries in new fields are greater than the depletion of the existing ones and the overall level of reserves is increasing. Nearly 30% of the gas sold in 2006 originated from the domestic production. Among other things, this was enabled by the commissioning of a new gas production facility in Jasionka near Rzeszów, development of the Biszcza-Księżopol fields and modernisation of the nitrogen removal plant in Odolanów.

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Abroad, the PGNiG Group carried out joint exploration efforts with Pakistan Petroleum Ltd. Subsidiary companies of the Group were also pursuing acquisition of exploration licences in Libya, Algeria, Egypt and Denmark. At the beginning of January 2007, a memorandum of understanding was signed with the Indian Gujard State Petroleum Company with respect to exploration and production of oil and gas in India, Egypt, Yemen and other countries in the Middle and Far East. The presence of the PGNiG Group in these markets offers additional opportunities for diversification of the sources and directions of gas supply. At the same time, the access to fields outside of Poland strengthens the position and recognition of the PGNiG brand in the international arena.

Ladies and Gentlemen,

in the last year, we launched a number of initiatives and projects that should have a long-term impact on our business activity. They have been defined in the Policy Directions for the PGNiG Group until 2011 adopted by the Management Board and the Supervisory Board. The document provides a set of guidelines with a view to optimizing the use of the Group's assets and structuring of the further development of the company.
We are undergoing a challenging process of change and transformation, which is aimed at the improvement of the Company's operating efficiency and increased cooperation within the Group in order to explore potential synergies. The year 2007 will be crucial for our future. The capabilities, unique expertise and commitment of nearly 30 thousand employees are our tremendous asset. In 2006, the primary objective was to build a favourable starting position for becoming a leading gas company in Central Europe and, subsequently, an active player in the international market. We hope that with our joint efforts we will ensure that Group is not only perceived as a reliable business partner in the Polish market, but also as a company that is increasingly well managed and is capable of facing the challenges of the liberalised European market.

Krzysztof Głogowski
President of the Management Board

Warsaw, May 2007