Polskie Górnictwo Naftowe i Gazownictwo SA

DIRECTORS' REPORT ON THE OPERATIONS OF PGNiG SA IN 2011

Warsaw, March 1st 2012

Contents

Chapter I: Company's highlights

1. Establishment of the Company

Polskie Górnictwo Naftowe i Gazownictwo Spółka Akcyjna (PGNiG SA), registered office in Warsaw, ul. Marcina Kasprzaka 25, was established as a result of transformation of state-owned enterprise Polskie Górnictwo Naftowe i Gazownictwo into a state-owned stock company. The Deed of Transformation and the Company's Articles of Association were executed in the form of a notarial deed dated October 21st 1996 (Rep. A No. 18871/96).

The Minister of State Treasury executed the Deed of Transformation in performance of the provisions of the Regulation of the President of the Polish Council of Ministers of September 30th 1996 on transformation of the state-owned enterprise Polskie Górnictwo Naftowe i Gazownictwo of Warsaw into a state-owned stock company.

On October 30th 1996, the Company was entered in the commercial register under the name Polskie Górnictwo Naftowe i Gazownictwo S.A. of Warsaw under entry No. RHB 48382. As of the registration date, the Company acquired legal personality. On November 14th 2001, the Company was entered into the Register of Entrepreneurs of the National Court Register under entry No. 0000059492.

Following the implementation of the Restructuring and Privatisation Programme for PGNiG SA adopted by the Polish Council of Ministers on October 5th 2004, the Polish Securities and Exchange Commission admitted PGNiG shares to public trading on May 24th 2005.

Based on a decision of the District Court for the Capital City of Warsaw of October 6th 2005, an increase of the PGNiG share capital increase was registered. Following the increase, the Company's share capital amounts to PLN 5.9bn and is divided into 5,900,000,000 shares, including:

- 4,250,000,000 Series A bearer shares with an aggregate par value of PLN 4,250m,
- 750,000,000 Series A1 bearer shares with an aggregate par value of PLN 750m,
- 900,000,000 Series B bearer shares with an aggregate par value of PLN 900m.

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.

2. Core business

PGNiG SA is the largest company in Poland operating in the area of hydrocarbon exploration and production, and trade in natural gas. PGNiG SA is the leader in all areas of the Polish gas sector, including natural gas import, exploration, oil and gas production, gas fuel storage and sale of natural gas.

Pursuant to its Articles of Association, the Company performs activities aimed at ensuring energy security of Poland. These relate in particular to the following:

- ensuring continuity of gas supplies to consumers and maintaining the necessary stocks of gas,
- ensuring safe operation of gas networks,
- balancing the gas system, managing operations and capacity of the power equipment connected to the common gas network,
- gas production.

3. PGNiG SA's organisational structure

On January 1st 2011, a new branch was established within PGNiG SA, namely the Emergency Rescue Station Branch in Kraków. The branch was formed on the basis of an organised part of business acquired by PGNiG SA from Poszukiwania Nafty i Gazu Kraków Sp. z o.o. The Branch conducts activities related to mining rescue operations and prevention of hazards to health and life of employees and to mining operations.

On March 29th 2011, the Algeria Branch was wound up. The decision to wind up the unit was made considering the complicated geopolitical situation in Algeria.

PGNiG SA has a number of branches. As at December 31st 2011, the PGNiG SA corporate structure comprised the Head Office and fifteen branches. Their core activities are presented in the table below:

Core activities of PGNiG SA's organisational units

Unit	Core activity
Head Office, Warsaw	Corporate supervision over the Company branches Supervision over the PGNiG Group as part of ownership supervision
Sanok Branch	Production of natural gas and crude oil Operating underground gas storage facilities Direct sale of natural gas which does not enter the national grid and of other products and services Exploration work
Zielona Góra Branch	Production of natural gas and crude oil Operating underground gas storage facilities Direct sale of natural gas which does not enter the national grid and of other products and services Exploration work
Odolanów Branch	Processing of nitrogen-rich natural gas into high-methane gas
Operating Branch in Pakistan	Exploration for and production of hydrocarbons in licence areas in Pakistan
Egypt Branch	Exploration for and production of hydrocarbons in licence areas in Egypt
Denmark Branch	Exploration for and production of hydrocarbons in licence areas in Denmark

Core activities of PGNiG SA's organisational units – continued

Branch	Core activity
Lower Silesian Gas Trading Division in Wrocław	Comprehensive customer service related to sale of natural gas and other products and services
Upper Silesian Gas Trading Division in Zabrze	
Carpathian Gas Trading Division in Tarnów	
Mazovian Gas Trading Division in Warsaw	
Pomeranian Gas Trading Division in Gdańsk	
Greater Poland Gas Trading Division in Poznań	
Storage System Operator in Warsaw	Gaseous fuel storage
Central Measurement and Testing Laboratory, Warsaw	Provision of services to ensure accuracy and reliability of measurements related to natural gas
Emergency Rescue Station Branch in Kraków	Provision of rescue services to the petroleum mining industry

As at December 31st 2011, PGNiG SA had foreign representative offices in Moscow (Russia), Brussels (Belgium), Kiev (Ukraine) and Vysokoye (Belarus).

<u>Changes in management policies</u>

In 2011, there were no material changes in the management policies of PGNiG SA.

On December 22nd 2011, the process of consolidation of construction and assembly companies in the Other Activities segment was completed. PGNiG Technologie Sp. z o.o. (as the surviving company) merged with ZRUG Sp. z o.o., Zakład Urządzeń Naftowych Naftomet Sp. z o.o., Budownictwo Naftowe Naftomontaż Sp. z o.o. and BUG Gazobudowa Sp. z o.o. Total assets of the target companies were transferred onto PGNiG Technologie Sp. z o.o.

4. Equity links

Polskie Górnictwo Naftowe i Gazownictwo S.A. holds shares in production and service companies. As at December 31st 2011, PGNiG SA had 37 related entities, including:

- 27 subsidiaries;
- 10 other related entities.

The table below presents related entities of PGNiG SA as at December 31st 2011.

PGNiG SA's related entities

	Name	Share capital (PLN)	Value of shares held by PGNiG SA (PLN)	% of ownership interest held by PGNiG SA	% of total vote held by PGNiG SA
	Subsidiaries				
1	Poszukiwania Nafty i Gazu Jasło Sp. z o.o.	100,000,000.00	100,000,000.00	100.00%	100.00%
2	Poszukiwania Nafty i Gazu Kraków Sp. z o.o.	105,231,000.00	105,231,000.00	100.00%	100.00%
3	Poszukiwania Nafty i Gazu NAFTA Sp. z o.o.	60,000,000.00	60,000,000.00	100.00%	100.00%
4	GEOFIZYKA Kraków Sp. z o.o.	64,400,000.00	64,400,000.00	100.00%	100.00%
5	GEOFIZYKA Toruń Sp. z o.o.	66,000,000.00	66,000,000.00	100.00%	100.00%
6	Poszukiwania Naftowe Diament Sp. z o.o.	62,000,000.00	62,000,000.00	100.00%	100.00%
7	Zakład Robót Górniczych Krosno Sp. z o.o.	26,903,000.00	26,903,000.00	100.00%	100.00%
8	PGNiG Norway AS (NOK) [1)]	1,092,000,000.00	1,092,000,000.00	100.00%	100.00%
9	Polish Oil and Gas Company – Libya B.V. (EUR)[1)]	20,000.00	20,000.00	100.00%	100.00%
10	PGNiG Sales & Trading GmbH (EUR)[1)]	10,000,000.00	10,000,000.00	100.00%	100.00%
11	Operator Systemu Magazynowania Sp. z o.o.	5,000,000.00	5,000,000.00	100.00%	100.00%
12	INVESTGAS S.A.	502,250.00	502,250.00	100.00%	100.00%
13	Dolnośląska Spółka Gazownictwa Sp. z o.o.	658,384,000.00	658,384,000.00	100.00%	100.00%
14	Górnośląska Spółka Gazownictwa Sp. z o.o.	1,300,338,000.00	1,300,338,000.00	100.00%	100.00%
15	Karpacka Spółka Gazownictwa Sp. z o.o.	1,484,953,000.00	1,484,953,000.00	100.00%	100.00%
16	Mazowiecka Spółka Gazownictwa Sp. z o.o.	1,255,800,000.00	1,255,800,000.00	100.00%	100.00%
17	Pomorska Spółka Gazownictwa Sp. z o.o.	653,646,000.00	653,646,000.00	100.00%	100.00%
18	Wielkopolska Spółka Gazownictwa Sp. z o.o.	1,033,186,000.00	1,033,186,000.00	100.00%	100.00%
19	Geovita Sp. z o.o.	86,139,000.00	86,139,000.00	100.00%	100.00%
20	PGNiG Energia S.A.	30,000,000.00	30,000,000.00	100.00%	100.00%
21	PGNiG Technologie Sp. z o.o.	166,914,000.00	166,914,000.00	100.00%	100.00%
22	BUD-GAZ PPUH Sp. z o.o.	51,760.00	51,760.00	100.00%	100.00%
23	Polskie Elektrownie Gazowe Sp. z o.o.	1,212,000.00	1,212,000.00	100.00%	100.00%
24	PGNiG SPV 1 Sp. z o.o.	20,000.00	20,000.00	100.00%	100.00%
25	PGNiG Finance AB (SEK)	500,000.00	500,000.00	100.00%	100.00%
26	B.S. and P.G. Gazoprojekt S.A.	4,000,000.00	3,000,000.00	75.00%	75.00%
27	NYSAGAZ Sp. z o.o.	9,881,000.00	6,549,000.00	66.28%	66.28%
	Name	Share capital (PLN)	Value of shares held by PGNiG SA (PLN)	% of ownership interest held by PGNiG SA	% of total vote held by PGNiG SA
	Other related entities				
28	System Gazociągów Tranzytowych EUROPOL GAZ S.A.	80,000,000.00	38,400,000.00	48.00%	48.00%
29	GAS-TRADING SA	2,975,000.00	1,291,350.00	43.41%	43.41%
30	InterTransGas GmbH (EUR) [1)]	200,000.00	100,000.00	50.00%	50.00%
31	„Dewon" Z.S.A. (UAH)[1)]	11,146,800.00	4,055,205.84	36.38%	36.38%
32	Sahara Petroleum Technology LLC w likwidacji (in liquidation) (OMR)[1)]	150,000.00	73,500.00	49.00%	49.00%
33	PFK GASKON S.A.	13,061,325.00	6,000,000.00	45.94%	45.94%
34	GAZOMONTAŻ S.A.	1,498,850.00	677,200.00	45.18%	45.18%
35	ZRUG Sp. z o.o. (Poznań)	3,781,800.00	1,515,000.00	40.06%	41.71%
36	ZWUG INTERGAZ Sp. z o.o.	4,700,000.00	1,800,000.00	38.30%	38.30%
37	ZRUG TORUŃ S.A.	5,150,000.00	1,300,000.00	25.24%	25.24%

[1)] In foreign currencies

5. Changes in equity interest

Changes in 2011:

- On February 9th 2011, TE-MA WOC Małaszewicze Terespol Sp. z o.o. w likwidacji (in liquidation) was deleted from the National Court Register.
- On February 10th 2011, POGC Trading GmbH was registered in Germany; the company's name was changed to PGNiG Sales & Trading GmbH. The company's new name was registered on August 25th 2011.
- On February 11th 2011, the bankruptcy proceedings concerning Huta Szkła Szczakowa S.A. w upadłości (in bankruptcy) were completed. On June 7th 2011, the company was deleted from the National Court Register.
- On April 29th 2011, PGNiG SA acquired Goldcup 5839 AB. Following the acquisition, the company's name was changed to PGNiG Finance AB. The company's purpose is to service the issues of PGNiG Eurobonds. Its share capital amounts to SEK 500,000 (Swedish krona). The company's new name was entered in the Register of Companies in Stockholm on June 20th 2011.

- On June 17th 2011, PGNiG acquired PGNiG SPV1 Sp. z o.o. whose purpose is to execute power projects. The company's share capital amounts to PLN 20,000 and is divided into 400 shares with a par value of PLN 50 per share.
- On December 14th 2011, the Court of Appeals dismissed PI GAZOTECH Sp. z o.o.'s appeal requesting that certain resolutions adopted by the Extraordinary General Meeting of PI GAZOTECH Sp. z o.o. on April 23rd 2004 be abrogated or declared invalid, including the resolution obliging PGNiG SA to make an additional contribution to equity in the amount of PLN 52m and resolution concerning a partial retirement of company shares. The Court's decision resulted in the reduction of PGNiG SA's equity interest in PI GAZOTECH Sp. z o.o. to 5.4%.

Changes in share capital of PGNiG SA's related entities in 2011:

- Share capital increase at PGNiG Energia S.A. by PLN 14,000,000 to PLN 20,000,000; all new issue shares were acquired by PGNiG SA. The increase was registered with the National Court Register on April 29th 2011.
- Share capital increase at NYSAGAZ Sp. z o.o. by PLN 3,081,000 to PLN 9,881,000; all new issue shares were acquired by PGNiG SA and covered by a non-cash contribution in the form of 27 gas-fired boiler houses. Upon the increase, PGNiG SA's share in the share capital of NYSAGAZ Sp. z o.o. increased to 66.3%. The capital increase was registered with the National Court Register on July 20th 2011.
- Share capital increase at PGNiG Norway AS by NOK 140,673,000, to NOK 1,092,000,000; all new issue shares were acquired by PGNiG SA. The capital increase was registered with the Norwegian commercial register on October 14th 2011.
- Share capital increase at Operator Systemu Magazynowania Sp. z o.o. by PLN 4,000,000, to PLN 5,000,000; all new issue shares were acquired by PGNiG SA. The increase was registered with the National Court Register on September 22nd 2011.
- Share capital increase at PGNiG Energia S.A. by PLN 10,000,000, to PLN 30,000,000; all new issue shares were acquired by PGNiG SA. The increase was registered with the National Court Register on October 21st 2011.
- Share capital increase at Pomorska Spółka Gazownictwa Sp. z o.o. by PLN 38,950,000, to PLN 653,646,000; all new issue shares were acquired by PGNiG SA and covered with a non-cash contribution in the form of the PGNiG gas transmission business segment. The increase was entered in the National Court Register on November 4th 2011.
- Share capital increase at PGNiG Technologie Sp. z o.o. by PLN 46,516,000, to PLN 166,914,000; all new issue shares were acquired by PGNiG SA. The increase was registered with the National Court Register on December 30th 2011.

Changes after the end of the financial year

On January 2nd 2012, the transformation of PNiG Jasło Sp. z o.o. into a joint-stock company was registered with the National Court Register.

On January 11th 2012, PGNiG SPV 1 Sp. z o.o. executed a final share purchase agreement with Vattenfall AB, whereby PGNiG SPV 1 Sp. z o.o. acquired 24,591,544 shares in Vattenfall Heat Poland S.A., which account for 99.8% of the company's share capital and confer the right to 99.8% of the total vote at the General Meeting of Vattenfall Heat Poland S.A.

On January 13th 2012, the Extraordinary General Meeting of PGNiG SPV 1 Sp. z o.o. adopted a resolution concerning an increase in the company's share capital by PLN 770,000,000, to PLN 770,020,000 by way of an issue of 15,400,000 new shares with a par value of PLN 50 per share. All new issue shares were acquired by PGNiG SA. The increase was registered with the National Court Register on January 25th 2012.

On February 16th 2012, the Extraordinary General Meeting of PGNiG Energia S.A. adopted a resolution concerning an increase in the company's share capital by PLN 11,000,000, to PLN 41,000,000, by way of an issue of 110,000 new shares with a par value of PLN 100 per share. All new issue shares were acquired by PGNiG SA.

On February 17th 2012, the Extraordinary General Meeting of Pomorska Spółka Gazownictwa Sp. z o.o. adopted a resolution to increase in the company's share capital by PLN 1,553,000, to PLN 655,199,000 by way of an issue of 1,533 new shares with a par value of PLN 1,000 per share. All new issue shares were acquired by PGNiG SA and paid for with an in-kind contribution in the form of a perpetual usufruct right to land, along with the ownership title to buildings and structures erected thereon.

Investments outside the group of related entities

As at the end of 2011, the par value of PGNiG SA's equity interests outside the group of related entities amounted to PLN 21.9m. In 2011, PGNiG SA disposed of 4,000,001 shares in Zakłady Azotowe w Tarnowie-Mościcach S.A. with a par value of PLN 5 per share at PLN 37 per share. During the financial year, PGNiG SA made no material equity investments outside the group of related entities.

6. Employment

The table below presents employment at the PGNiG Group as at December 31st 2011, by segments. As the PGNiG Head Office provides services to all segments in the Group, it is disclosed separately.

Employment by segments (no. of staff)

	2011	2010
PGNiG Head Office	838	840
Exploration and Production	4,405	4,375
Trade and Storage	3,710	3,701
Other Activities	38	39
Total	8,991	8,955

On October 25th 2011, PGNiG SA and representative trade union organisations entered into an agreement on mass redundancies at the PGNiG Head Office. The mass redundancies took place in December 2011. Actual reduction of the staffing levels at the PGNiG Head Office will take effect in the course of 2012 due to varying lengths of the notice periods given to the dismissed employees.

Since January 2009, the Group has operated the Programme for Employment Streamlining and Redundancy Payments to the Employees of the PGNiG Group for 2009–2011 (Stage 3). The term of the Programme has been extended for another calendar year.

Its operation is based on the "stand-by" principle. It may be implemented in extraordinary circumstances and requires all the companies to follow a procedure which is uniform across the Group.

In 2011, the Programme was implemented in four companies of the PGNiG Group: ZUN Naftomet Sp. z o.o., BUG Gazobudowa Sp. z o.o., MSG Sp. z o.o. and ZRUG Pogórska Wola Sp. z o.o., and covered 178 employees. In 2011, funds from the capital reserve designated as Central Restructuring Fund were allocated to one-off benefits to 159 dismissed employees of ZUN Naftomet Sp. z o.o. and BUG Gazobudowa Sp. z o.o.

7. Sale and acquisition of natural gas

PGNiG SA recorded revenue of PLN 21.8bn, 93% of which was derived from sales of natural gas.

Revenue (PLNm)

	2011	2010
Natural gas, including:	20,382.7	19,300.7
– high-methane gas	19,163.5	18,109.6
– nitrogen-rich gas	1,219.2	1,191.1
Crude oil	1,095.2	838.6
Condensate	5.1	3.2
Helium	57.5	44.1
Propane-butane	60.5	50.5
Gas storage services	31.5	31.7
Geophysical and geological services	59.4	27.2
Other sales	128.6	119.5
Total	21,820.5	20,415.5

In 2011, PGNiG SA sold 14.4 billion cubic metres of natural gas, with 95% of that amount represented by sales from the transmission and distribution systems and the balance – by direct sales from gas fields.

Natural gas sales volume (million cubic metres)

	2011	2010
Trade and Storage	13,699.2	13,743.0
Exploration and Production	681.8	673.8
Total	14,381.0	14,416.8

In 2011, the volume of natural gas acquired by PGNiG SA was 15.4 billion cubic metres, with 71.1% of that amount sourced from imports, mostly from Russia. Natural gas production from fields in Poland represented 28.2% of the total volume acquired. The table below presents the structure of natural gas supplies to the Group, measured as high-methane gas equivalent.

Supply sources of natural gas (million cubic metres)

	2011	2010
Imports	10,915.3	10,066.4
Domestic production	4,329.4	4,220.4
Domestic suppliers	112.3	96.1
Total	15,357.0	14,382.9

Chapter II: Company’s governing bodies

1. Management Board

Pursuant to PGNiG SA’s Articles of Association, its Management Board is composed of two to seven members. The number of Management Board members is determined by the Supervisory Board. Individual members or the entire Management Board are appointed for a joint three-year term of office.

A member of the Management Board is appointed following a qualification procedure carried out pursuant to the Regulation of the Polish Council of Ministers of March 18th 2003 concerning qualification procedures for members of management boards of certain commercial-law companies (Dz. U. No. 55, item 476). The Regulation does not apply to Management Board members elected by employees.

As long as the State Treasury remains a shareholder of the Company and the Company’s average annual headcount exceeds 500, the Supervisory Board appoints one person elected by the Company's employees to serve on the Management Board during its term. The Supervisory Board adopts the rules governing election and removal from office of the Management Board member representing the employees, and the rules of by-elections.

Each member of the Management Board may be removed from office or suspended from their duties by the Supervisory Board or the General Meeting.

As at January 1st 2011, the composition of the PGNiG Management Board was as follows:

- Michał Szubski – CEO and President of the Management Board
- Radosław Dudziński – Vice-President, Strategy
- Sławomir Hinc – Vice-President, Finance
- Marek Karabuła – Vice-President, Petroleum Mining
- Mirosław Szkałuba – Vice-President, Trade

At its meetings on January 12th 2011 and March 8th 2011, the Supervisory Board appointed the President and members of the PGNiG Management Board for another joint term of office starting on March 13th 2011. The following members of the Management Board were reappointed for the three-year term: Michał Szubski (CEO and President), Radosław Dudziński, Sławomir Hinc, Marek Karabuła and Mirosław Szkałuba.

Mirosław Szkałuba is the Management Board member elected by employees in the elections held in January and February 2011.

As at December 31st 2011, the composition of the PGNiG Management Board was as follows:

- Michał Szubski – CEO and President of the Management Board
- Radosław Dudziński – Vice-President, Strategy
- Sławomir Hinc – Vice-President, Finance
- Marek Karabuła – Vice-President, Petroleum Mining
- Mirosław Szkałuba – Vice-President.

On December 19th 2011, Michał Szubski, CEO and President of the PGNiG Management Board, resigned from his position.

Contracts with Management Board Members

The employment contracts concluded with all the Management Board members contain a clause in Par. 8, which reads: "In the event of removal from office or termination of this employment contract for reasons other than breach of basic duties under the employment contract, the employee is entitled to a severance pay equal to three times the employee's monthly salary."

As at December 31st 2011, the non-competition agreements concluded with the President, Mr. Michał Szubski, and Vice-Presidents, Messrs. Radosław Dudziński, Sławomir Hinc, Mirosław Szkałuba and Waldemar Wójcik were in force. The non-competition agreements continue in force for 12 months following termination of the employment relationship. In return for observing the competition ban during the term of the non-competition agreement, a Management Board member is entitled to a monthly compensation of 100% of such member's average gross remuneration for the last three months received in connection with the legal relationships between the member and the Company.

2. Supervisory Board

Pursuant to the Articles of Association of PGNiG SA, the Supervisory Board is composed of five to nine members, appointed by the General Meeting for a three-year common term of office.

As long as the State Treasury holds an equity interest in the Company, the State Treasury, represented by the minister competent for matters pertaining to the State Treasury, acting in consultation with the minister competent for economic affairs, has the right to appoint and remove one member of the Supervisory Board.

In accordance with the Articles of Association, the General Meeting appoints one independent member of the Supervisory Board. The independent Supervisory Board member is elected in separate voting.

Written nominations of candidates for the position of an independent Supervisory Board member may be submitted to the Chairman of the General Meeting by the shareholders present at the General Meeting whose agenda includes the election of such a Supervisory Board member. Any such written proposal should be submitted along with a written representation by a given candidate to the effect that the candidate agrees to stand for the election and meets the criteria for an independent member of the Supervisory Board. If no candidates for the position are proposed by the shareholders, such candidates are nominated by the Supervisory Board.

If the Supervisory Board is composed of up to six members, two members are appointed from among the candidates elected by the Company's employees. If the Supervisory Board is composed of seven to nine members, three members are appointed from among the candidates elected by the Company's employees.

As at January 1st 2011, the composition of the PGNiG Supervisory Board was as follows:

- Stanisław Rychlicki – Chairman of the Supervisory Board
- Marcin Moryń – Deputy Chairman of the Supervisory Board
- Mieczysław Kawecki – Secretary of the Supervisory Board
- Grzegorz Banaszek – Member of the Supervisory Board
- Agnieszka Chmielarz – Member of the Supervisory Board
- Mieczysław Puławski – Member of the Supervisory Board
- Jolanta Siergiej – Member of the Supervisory Board.

Upon the expiry of the Supervisory Board's term of office, on April 20th 2011, the General Meeting of PGNiG SA appointed members of the PGNiG Supervisory Board for a new joint term of office starting on May 1st 2011. Stanisław Rychlicki, Marcin Moryń, Mieczysław Kawecki, Grzegorz Banaszek, Agnieszka Chmielarz, Mieczysław Puławski (the independent member) and Jolanta Siergiej were re-appointed for the three-year term.

Agnieszka Chmielarz, Mieczysław Kawecki and Jolanta Siergiej are Supervisory Board members elected by employees in the elections held in January and February 2011.

As at December 31st 2011, the composition of the PGNiG Supervisory Board was as follows:

- Stanisław Rychlicki – Chairman of the Supervisory Board
- Marcin Moryń – Deputy Chairman of the Supervisory Board
- Mieczysław Kawecki – Secretary of the Supervisory Board
- Grzegorz Banaszek – Member of the Supervisory Board
- Agnieszka Chmielarz – Member of the Supervisory Board
- Mieczysław Puławski – Member of the Supervisory Board
- Jolanta Siergiej – Member of the Supervisory Board.

On January 5th 2012, Mr. Stanisław Rychlicki, Chairman of the Supervisory Board, tendered his resignation from the position with effect from January 11th 2012.

On January 12th 2012, the Extraordinary General Meeting of PGNiG SA removed Mr. Grzegorz Banaszek from the Supervisory Board and appointed Mr. Wojciech Chmielewski. Also on January 12th 2012, the Minister of State Treasury, acting in consultation with the Minister of Economy, appointed Mr. Janusz Pilitowski to serve on the PGNiG Supervisory Board.

On January 13th 2012, the PGNiG Supervisory Board appointed Mr. Wojciech Chmielewski as its Chairman.

<u>Remuneration of management and supervisory personnel</u>

For information on the remuneration paid to management and supervisory personnel, see the annual separate financial statements for the year ended December 31st 2011 (Note 36.4).

Chapter III: Shareholder structure

As at December 31st 2011, the share capital of PGNiG SA 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 State Treasury was the only shareholder directly holding a large block of PGNiG shares. The shares of all series, that is Series A, A1 and B, were ordinary bearer shares and each share conferred the right to one vote at the General Meeting. The shareholder structure as at December 31st 2011 is presented in the table below:

Shareholder structure

Shareholder	Number of shares as at 31.12.2011	% of share capital held as at 31.12.2011	Number of votes conferred by shares held	% of total vote at GM as at 31.12.2011
State Treasury	4,272,063,451	72.41%	4,272,063,451	72.41%
Other shareholders	1,627,936,549	27.59%	1,627,936,549	27.59%
Total	5,900,000,000	100.00%	5,900,000,000	100.00%

<u>PGNiG shares and shares in the related undertakings of PGNiG SA held by management and supervisory personnel</u>

The table below presents PGNiG shares held by the management and supervisory personnel as at December 31st 2011:

PGNiG shares held by the management and supervisory personnel

Name	Position	Number of shares	Par value of shares (PLN)
Michał Szubski	CEO, President of the Management Board	6,825	6,825
Mirosław Szkałuba	Vice-President of the Management Board	9,425	9,425
Stanisław Rychlicki	Chairman of the Supervisory Board	9,897	9,897
Mieczysław Kawecki	Secretary of the Supervisory Board	19,500	19,500
Jolanta Siergiej	Member of the Supervisory Board	9,425	9,425
Mieczysław Jakiel	Proxy	30,101	30,101
Kazimierz Chrobak	Proxy	19,500	19,500

<u>Agreements which may give rise to future changes in the interests held by the existing shareholders or bondholders</u>

As at the date of this report, PGNiG SA was not aware of any agreements which could lead to future changes in the equity interests held in the Company by its existing shareholders.

<u>Control of employee stock option plans</u>

On October 1st 2010, the eligible employees' rights to acquire PGNiG shares free of charge expired. As a result, agreements for free-of-charge disposal of the Company shares may be entered into only by the heirs of eligible employees who filed – on or before October 1st 2010 – a petition with court seeking a ruling that they had acquired the eligible employees' rights by way of inheritance. As at December 31st 2011, 59,248 eligible employees or their heirs (96.3% of the total number of eligible persons) acquired 727,936,548 shares, representing 97.1% of the pool of shares available to be acquired free of charge by eligible persons.

55,250 PGNiG shares acquired free of charge by members of the Company's Management Board were admitted to stock-exchange trading on July 1st 2011.

Performance of the PGNiG stock

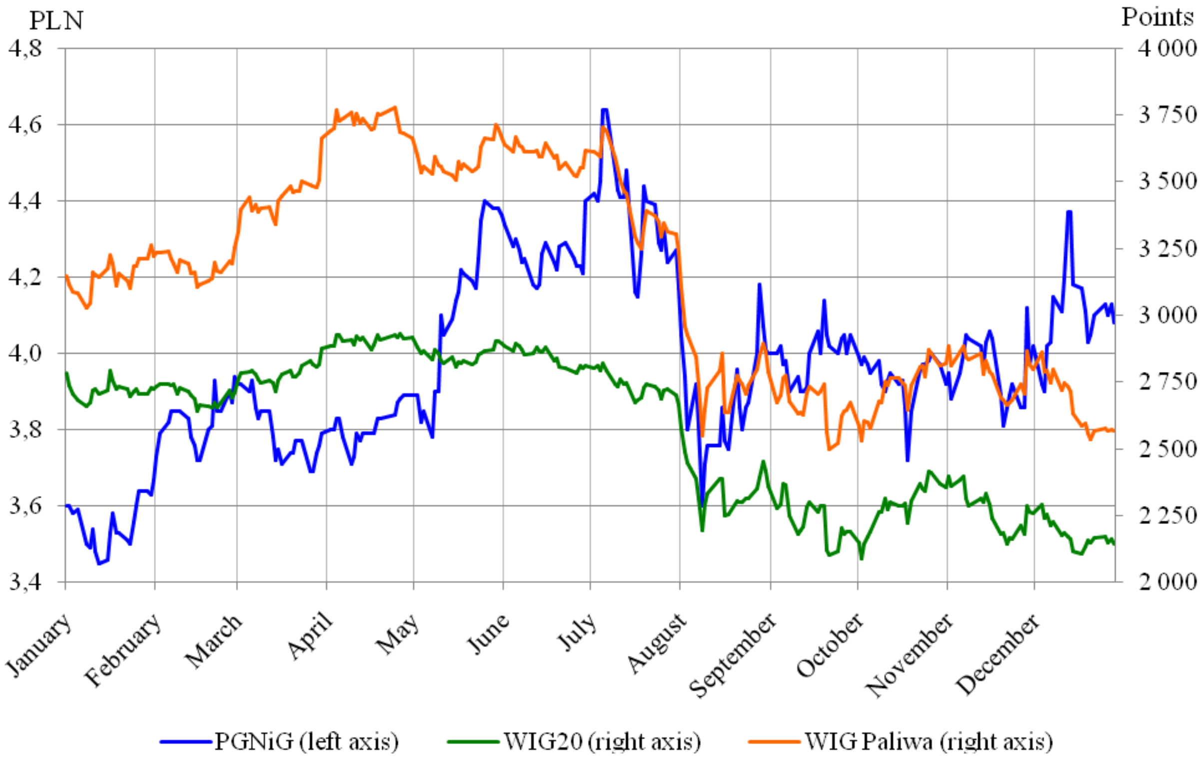
PGNiG shares have been listed at the Warsaw Stock Exchange since October 20th 2005. As at December 31st 2011, the Company was included in the following indices:

- WIG – all-cap index of the WSE
- WIG20 – blue-chip index of the 20 largest and most liquid companies
- WIG-Paliwa – index of the fuel sector companies
- WIG-div – total return index of 30 companies with the highest dividend yields and regular dividend payments
- WIG-Poland – index of Polish companies listed on the WSE
- Respect Index – index of socially responsible companies.

In 2011, the rate of return on the PGNiG stock was 14.3% (PLN 0.12 per share), or 17.6% including dividend income. For the period from the first listing until December 31st 2011, the rate of return on the PGNiG stock was 7.1%. Investors who acquired the PGNiG shares on the WSE at their issue price earned a 36.9% return.

The following figure presents the relative performance of the PGNiG stock against the WIG 20 and WIG Paliwa indices. The table shows the values of the WSE indices and the PGNiG share price in 2011.

PGNiG share price vs. the WIG 20 and WIG Paliwa indices



WSE indices and the PGNiG share price

	Value/price as at Dec 31 2010	2011 high	2011 low	Value/price as at Dec 31 2011	PGNiG's weight in the index as at Dec 31 2011
WIG	47,490	50,372	36,549	37,595	1.0%
WIG20	2,744	2,933	2,090	2,144	1.4%
WIG-Fuels	3,079	3,776	2,499	2,568	19.0%
Respect Index	2,259	2,577	1,944	2,005	3.4%
PGNiG SA	PLN 3.57	PLN 4.64	PLN 3.45	PLN 4.08	-

Source: WSE.

Chapter IV: Regulatory environment

PGNiG SA's activities are regulated by the following laws:

- Polish Energy Law of April 10th 1997 (consolidated text in Dz. U. of 2006, No. 89, item 624, as amended) with secondary legislation, to the extent the act governs gas fuel trading, distribution and storage.
- Act on Stocks of Crude Oil, Petroleum Products and Natural Gas, and 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 (Dz. U. of 2007, No. 52, item 343, as amended) with the secondary legislation, to the extent the act governs international trade in natural gas.
- Polish Geological and Mining Law of February 4th 1994 (Dz. U. of 1994, No. 27, item 96, as amended), to the extent the act governs production and sale of gas.

1. Polish Energy Law

The activities of PGNiG SA in the area of gas fuel trading, distribution and storage are regulated and require a licence from and a tariff approved by the President of the Energy Regulatory Office. The tariff determines the prices of gas fuels.

In 2011, the Polish Energy Law was amended several times, in particular with respect to the electricity generation sector. The most significant amendments relating to the gas sector provided for regulations governing the change of a gas fuel supplier by customers and determination of rules for obtaining certificates of origin for biogas supplied to the gas distribution network. Additionally, amendment to 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 necessitated the introduction of relevant changes to the Polish Energy Law with respect to obtaining the licence for international trade in natural gas

1.1. Licences

As at December 31st 2011, PGNiG SA held the following licences granted by the President of the Polish Energy Regulatory Office under the Energy Law:

- one licence for trade in gas fuels
- one licence for international trade in natural gas
- one licence for storage of gas fuels
- one licence for trade in liquid fuels
- one licence for electricity production
- one licence for electricity trading.

In 2010, the President of the Energy Regulatory Office refused to approve changes in the working capacities of the Husów Underground Gas Storage Facility, due to the technical conditions determining the facility's operations. The President of the Energy Regulatory Office also refused to exclude from the licence scope the storage facility working capacities which are used by the production segment or by the Transmission System Operator, as requested by PGNiG SA, citing the Polish Energy Law under which such capacities are not storage facilities.

On November 2nd 2010, PGNiG SA appealed against that decision to the Regional Court of Warsaw – the Court of Competition and Consumer Protection. Pursuant to its decision of June 21st 2011, the Court of Competition and Consumer Protection initiated proceedings on the case. As in November

2011 a procedure was initiated to make storage capacities previously used for production purposes available on a TPA (Third Party Access) basis, on January 13th 2012 PGNiG SA withdrew the appeal.

At the same time, PGNiG SA filed a request for a change in the licence. In order to make the scope of the licence compatible with the Polish Energy Law, the Company requested that the scope of licensed activities be defined as "storage of gas fuels in storage facilities with the use of underground gas storage facilities specified in the licence." PGNiG SA also requested approval of the change in the working storage capacities of the Strachocina Underground Gas Storage Facility, the Wierzchowice Underground Gas Storage Facility and the Mogilno Cavern Underground Gas Storage Facility due to their expansion; and of the Husów Underground Gas Storage Facility due to technological considerations determining the facility's operations. As at the date of this report, the proceedings were pending.

By virtue of a decision of the President of the Energy Regulatory Office of July 11th 2011, PGNiG SA obtained a licence for electricity trading for the period from July 12th 2011 to December 31st 2030.

1.2. Tariff policy

Dependence of PGNiG SA's revenue on the tariffs approved by the President of the Energy Regulatory Office is one of the factors affecting the Group's regulated business. Tariffs are crucial to the Company's ability to generate revenue that would cover incurred justified costs plus return on capital employed and a reasonable margin. Gas prices and charges are directly connected with the applied tariff preparation methodology.

The tariff preparation methodology is based on the determination of prices and charges against forecast costs and gas sales targets. In accordance with the applicable regulatory policies, the cost of acquisition of natural gas from all sources, that is of both imported and domestically produced gas, is taken into account in the calculation of prices of gas fuels. In practice this means that both imported and domestically produced gas is subject to price regulation. Given that the current prices of imported gas are higher than those of domestically produced gas, inclusion of the cost of domestically produced gas in the cost basket, used for the purpose of pricing calculations, resulted in a situation where the tariff prices (applicable in settlements with customers) were determined below the cost of acquisition of imported gas.

Settlements with customers with which PGNiG SA had sale agreements were based on rules, prices and charges specified in the tariffs approved by the President of the Energy Regulatory Office.

1.3. Changes in tariffs

Until July 14th 2011, settlements with customers were based on the Gas Fuel Tariff (Part A – Gas Fuel Supply Tariff No. 3/2010); the tariff's gas fuel price was changed by an adjustment effective as of January 1st 2011.

On February 11th 2011, PGNiG SA applied to the President of the Energy Regulatory Office requesting a change to the Gas Fuel Tariff (Part A – Gas Fuel Supply Tariff No. 3/2010). The Company requested a change of the gas fuel price and an extension of the effective term of the changed tariff until May 31st 2011. As the term for which the tariff was approved expired, the President of the Energy Regulatory Office URE discontinued the proceedings by virtue of its decision of May 16th 2011.
On March 30th 2011, PGNiG SA applied to the President of the Energy Regulatory Office requesting approval of Gas Fuel Tariff (Part A – Gas Fuel Supply Tariff No. 4/2011).

In its decision of June 30th 2011, the President of the Energy Regulatory Office approved the Gas Fuel Tariff (Part A – Gas Fuel Supply Tariff No. 4/2011) which has been used in settlements with customers since July 15th 2011.Average prices and charge rates for the supply of high-methane gas E, Lw nitrogen-rich gas and Ls nitrogen-rich gas were increased by 8.9%, 7.6% and 6.3%, respectively.

The new tariff introduced a broader range of settlement options available to customers in tariff groups 1-3, who will be able to choose a settlement system suitable to their needs. Customers in tariff groups 6-11 are classified according to the gas consumption variance ratio. Based on this criterion, a customer may be classified to one of three (instead of two, as was the case previously) tariff groups (A, B, C), depending on the assigned ratio value. Additionally, customers may now enter into agreements providing for gas collection on an intermittent basis.

On October 25th 2011, PGNiG SA applied to the President of the Energy Regulatory Office requesting approval of:

- change to the Gas Fuel Tariff (Part A – Gas Fuel Supply Tariff No. 4/2011) with respect to gas fuel prices, which was to be applied in settlements with customers from January 1st 2012 to March 31st 2012.
- change to the Gas Fuel Tariff (Part A – Gas Fuel Supply Tariff No. 5/2012), which was to be applied in settlements with customers from January 1st 2012 to March 31st 2012.

With respect to the request for change to the Gas Fuel Tariff (Part A – Gas Fuel Supply Tariff No. 4/2011) the President of the Energy Regulatory Office, by virtue of a decision of January 11th 2012, refused to approve of the change. With respect to the request for approval of the Gas Fuel Tariff (Part A – Gas Fuel Supply Tariff No. 5/2012), the proceedings had are pending.
The following tables present the average tariffs (PLN per cubic meter) used in settlements with customers purchasing gas fuels, by fuel type and place of receipt.

Area covered by Dolnośląska Spółka Gazownictwa Sp. z o.o.

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
W-1	2.4623	2.5779	4.7%
W-2	1.9047	2.0167	5.9%
W-3	1.7238	1.8340	6.4%
W-4	1.5928	1.7036	7.0%
W-5 – W-7C	1.4474	1.5629	8.0%
W-8A – W-10C	1.2090	1.3185	9.0%

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
S-1	1.7738	1.8537	4.5%
S-2	1.3553	1.4415	6.4%
S-3	1.2334	1.3152	6.6%
S-4	1.0765	1.1911	10.7%
S-5 – S-7B	1.0520	1.1225	6.7%
S-8 – S-10	0.9309	1.0113	8.6%
Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
Z-1	1.3764	1.4575	5.9%
Z-2	1.2553	1.3255	5.6%
Z-3	1.1062	1.1749	6.2%
Z-4	0.9908	1.0954	10.6%
Z-5 – Z-7B	1.0289	1.0825	5.2%

Area covered by Górnośląska Spółka Gazownictwa Sp. z o.o.

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
W-1	2.4154	2.5468	5.4%
W-2	1.9701	2.0803	5.6%
W-3	1.6906	1.8014	6.6%
W-4	1.6085	1.7314	7.6%
W-5 – W-7C	1.4552	1.5854	8.9%
W-8A – W-11C	1.2053	1.3243	9.9%

Area covered by Karpacka Spółka Gazownictwa Sp. z o.o.

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
W-1	2.3037	2.4284	5.4%
W-2	1.8709	1.9928	6.5%
W-3	1.6224	1.7450	7.6%
W-4	1.5688	1.6960	8.1%
W-5 – W-7C	1.4654	1.5918	8.6%
W-8A – W-10C	1.1805	1.2933	9.6%

Area covered by Mazowiecka Spółka Gazownictwa Sp. z o.o.

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
W-1	2.6563	2.8082	5.7%
W-2	1.7818	1.9019	6.7%
W-3	1.5811	1.7044	7.8%
W-4	1.5372	1.6918	10.1%
W-5 – W-7C	1.4119	1.5658	10.9%
W-8A – W-10C	1.1142	1.2341	10.8%

Area covered by Pomorska Spółka Gazownictwa Sp. z o.o.

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
W-1	2.5089	2.6499	5.6%
W-2	1.9095	2.0396	6.8%
W-3	1.6856	1.8144	7.6%
W-4	1.6121	1.7530	8.7%
W-5 – W-7C	1.4680	1.6114	9.8%
W-8A – W-10C	1.1857	1.3075	10.3%

Area covered by Wielkopolska Spółka Gazownictwa Sp. z o.o.

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
W-1	2.5548	2.6742	4.7%
W-2	1.8365	1.9479	6.1%
W-3	1.6972	1.8085	6.6%
W-4	1.6031	1.7181	7.2%
W-5 – W-7C	1.4125	1.5291	8.3%
W-8A – W-10C	1.1610	1.2698	9.4%

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
S-1	1.7685	1.8642	5.4%
S-2	1.3279	1.4032	5.7%
S-3	1.1944	1.2723	6.5%
S-4	1.1009	1.1974	8.8%
S-5 – S-7B	1.0513	1.1246	7.0%
S-8 – S-10	-	-	

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
Z-1	1.6174	1.6976	5.0%
Z-2	1.2034	1.2649	5.1%
Z-3	1.0664	1.1314	6.1%
Z-4	0.9826	1.0645	8.3%
Z-5 – Z-7B	0.9588	1.0184	6.2%

Customers connected to the transmission grid of OGP GAZ-SYSTEM S.A.

Tariff group	Tariff No. 3/2010	Tariff No. 4/2011	Change (%)
	1	2	2/1
E-1A – E-2C	1.0630	1.1818	11.2%
Lw-1 – Lw-2	0.8271	0.9130	10.4%
Ls-1 – Ls-2	0.6730	0.7564	12.4%

In its decision of May 12th 2011, the President of the Energy Regulatory Office, in response to a request from PGNiG SA, extended the term of Gas Fuel Tariff (Part B – Gas Fuel Storage Services Tariff No. 1/2010) until September 30th 2011. On July 22nd 2011, PGNiG SA applied to the President of the Energy Regulatory Office requesting approval of a new Gas Fuel Storage Services Tariff. On November 16th 2011, the President of the Energy Regulatory Office approved the Gas Fuel Tariff

(Part B – Gas Fuel Storage Services Tariff No. 1/2011), effective in settlements with customers as of December 1st 2011.

The new tariff introduced charge rates applicable to storage services provided as follows:
- in the form of long-term, short-term or daily services
- on a continuous or intermittent basis
- in the form of packages, flexible packages or individual services.

On January 13th 2012, PGNiG SA applied to the President of the Energy Regulatory Office requesting approval of a new Gas Fuel Storage Services Tariff (Part B – Gas Fuel Storage Services Tariff No. 1/2012), which is to be effective in settlements with customers from April 1st 2012 to Match 31st 2013. The tariff submitted for approval takes into account a change in storage charge rates relating to the expected commissioning of new storage capacities (180m cubic meters in the Strachocina Underground Gas Storage Facility and 34m cubic metres in the Mogilno Cavern Underground Gas Storage Facility).

2. Act on stocks of crude oil, petroleum products and natural gas

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 regulates matters related to ensuring the national fuel security, and setting the rules for building up, maintaining, and financing stocks of natural gas by those energy companies whose business involves international trade in natural gas or which import gas for their own needs. With respect to the business activity of PGNiG SA, the Act:

- sets the timetable for building up the mandatory stock of natural gas: the volume of mandatory stock should cover 20 days’ average daily imports of gas as of October 1st 2010, and 30 days’ average daily imports of gas as of October 1st 2012;
- provides that the return on the capital employed in the storage business should be at least 6%;
- stipulates that the cost related to maintaining, releasing and restocking the reserves represents justified operating expenses within the meaning of Art. 3.21 of the Polish Energy Law.

On December 4th 2011, the amended 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 came into force. The amendment provides for:

- the possibility to store mandatory stocks in another EFTA member state, upon fulfilment of certain conditions set in the Act,
- the possibility to exempt a power utility company whose business involves international trade in natural gas or an entity which imports natural gas from the obligation to keep mandatory stock, if the number of their customers does not exceed 100 thousand and the natural gas volume imported in a calendar year does not exceed 100m cubic metres.

3. Polish Geological and Mining Law

The Polish Geological and Mining Law of February 4th 1994 regulates:

- carrying out geological work;
- extracting minerals from deposits;
- storing waste matter in rock mass, including in worked-out caverns;

- protection of mineral deposits, underground waters and other elements of the environment in connection with geological works and extraction of minerals.

The provisions of the Geological and Mining Law also govern business activities in the field of tankless storage of substances in rock mass, including in worked-out caverns.

Business activities involving exploration for and appraisal of mineral deposits, extraction of minerals from deposits, tankless storage of substances and storage of waste matter in rock mass, including in worked-out caverns, require licences.

Geological and mining activities are subject to supervision by competent geological administration bodies and mining supervision authorities. The Geological and Mining Law provides for criminal sanctions for failure to comply with its regulations, and specifies the upper and lower limits of royalty fees.

In 2011, the Ministry of Environment awarded PGNiG SA seven licences for exploration for and appraisal of crude oil and natural gas deposits, the terms of 21 licences were extended and one licence expired. Additionally, in 2011, six licences for production of crude oil and natural gas from deposits were obtained, while three licences expired. In the reviewed period, there were no changes to the licences for underground gas storage or licences for waste matter storage.

As at December 31st 2011, PGNiG SA held the following licences, granted pursuant to the Geological and Mining Law:

- 95 licences for exploration for and appraisal of crude oil and natural gas deposits
- 1 licence for appraisal of a salt deposit
- 225 licences for production of crude oil and natural gas from deposits
- 9 licences for underground gas storage (underground gas storage facilities)
- 3 licences for storage of waste

The New Polish Geological and Mining Law of June 9th 2011 (Dz.U. of 2001, No. 63, item 638) became effective as of January 1st 2012. The Act satisfies the requirements of the Directive 94/22/EC of the European Parliament and of the Council of May 30th 1994. The Act introduces the tender procedure for the licence for exploration for and appraisal of hydrocarbons and for production of hydrocarbons, superceding the previous tender procedure with respect to the establishment of mining usage rights.

4. Regulatory risks

Polish Energy Law

Further changes in the laws governing operation of the gas sector companies are to be expected in 2012. First of all, the Gas Law is to be adopted; the new law will supersede the Energy Law and 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, with respect to the regulation of the gas industry. The Gas Law will also implement the regulations included in the Third Energy Package adopted by the European Parliament, including the Directive of the European Parliament and of the Council concerning common rules for the internal market in natural gas, repealing Directive 2003/55/EC.

Work is also in progress on amending the Regulation of the Minister of Economy on detailed rules for determining and calculating tariffs for gas fuels and on settlements in gas fuels trading (the Tariff Regulation).

Legal changes, including delays in amending legal acts, create risks stemming from uncertainty as to the scope of regulatory changes and shorter time for adaptation to such changes, which might adversely affect the financial performance and growth prospects of PGNiG SA.

Act on Mandatory Stocks

The amendment of 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 a Disruptions on the Petroleum Market has limited the number of entities required to keep mandatory stocks to energy companies importing natural gas for resale. Additionally, the amended act allows for exemption from the obligation to keep mandatory stocks (upon fulfilment of certain conditions defined in the act) and ability to keep mandatory stocks within the territory of another EFTA member state.

The above change may help PGNiG's competitors reduce their operating costs, and thus have a negative effect on the Company's competitive position.

Energy Efficiency Act

The Energy Efficiency Act came into force on August 11th 2011. The Act implements Directive 2006/32/EC of the European Parliament and of the Council of April 5th 2006 on energy end-use efficiency and energy services. The Energy Efficiency Act establishes a national target for economical energy use, according to which savings of end-use energy until 2016 should be no less than 9% of the annual national consumption of energy. In line with the provisions of the new act, PGNiG SA, as a trading company, is required to purchase energy efficiency certificates or, alternatively, to pay the non-compliance penalty. This will drive up the cost of regulated activities and, consequently, inflate the price paid for gas by customers.

Tariff calculation

PGNiG SA's ability to cover the costs of its core operations depends on prices and charge rates approved by the President of the Energy Regulatory Office. When approving tariffs for a given period, the President of the Energy Regulatory Office takes into consideration external factors which are beyond PGNiG SA's control. In an attempt to protect customers, the President of the Energy Regulatory Office may consider certain business costs as unjustified. Moreover, the President of the Energy Regulatory Office does not always agree the assumptions made by PGNiG SA with respect to the main cost drivers and profit targets allowing for business risk. Consequently, the Energy Regulatory Office frequently refuses to approve tariff prices and charge rates applied for by PGNiG SA. Lower tariff prices and charges might adversely affect PGNiG SA's profitability.

In 2011, the President of the Energy Regulatory Office once again unilaterally extended the effective period of an applicable tariff. The Company believes that such actions by the President of the Energy Regulatory Office create a risk of a tariff being calculated below costs, as it does not account for the cost of supply of gas fuel to customers in the period by which the tariff effective period is extended by the President of the Energy Regulatory Office. As a result, it should be expected that in the next round of tariff approval proceedings this factor may be taken into consideration in the tariff calculation. Moreover, the President of the Energy Regulatory Office protracts the tariff approval proceedings, and tariffs are approved at later dates than those originally requested by PGNiG SA.

Demand for natural gas

The current methodology for calculation of prices and charge rates is based on demand forecasts; accordingly, revenue is exposed to forecasting risk. Inaccurate estimates of demand, affecting the accuracy of forecast purchase and supply volumes as well as costs on which the determinations of prices and charge rates are based, may adversely affect the Group's financial performance. An increase in demand from customers above the forecast level would necessitate additional purchases under all existing contracts which allow such additional (often more expensive) purchases.

Purchase price of imported gas

Prices of imported gas are denominated in USD or EUR and are based on indexation formulae reflecting the prices of petroleum products. Changes in foreign exchange rates and prices of petroleum products materially affect the cost of imported gas. Material changes in prices of fuels on the international markets affect the prices of imported gas. Any accurate forecast of changes of natural gas prices is encumbered with a high risk of error. There can be no assurance that despite the legal possibility of adjusting prices approved for a tariff term an increase in the price of imported gas may not be fully passed on to customers or the changes in gas selling prices may lag behind the changes in its import prices.

Chapter V: Exploration and Production

The segment's business focuses on extracting hydrocarbons from underground formations and preparing products for sale. The segment comprises the entire process of oil and gas exploration and production, starting from geological analyses, through geophysical surveys and drilling work, to field development and hydrocarbon production. The segment's gas storage needs are satisfied by the Brzeźnica, Daszewo, Strachocina, Swarzów and Bonikowo underground gas storage facilities.

1. Exploration

In 2011, PGNiG SA was engaged in exploration for both conventional and unconventional gas (shale gas and tight gas). In Poland, PGNiG SA conducted, both on its own and in cooperation with partners, exploration and appraisal work, specifically in the Carpathian Mountains, Carpathian Foothills and Polish Lowlands. In the licence areas in Poland, drilling work was under way on 28 boreholes, including 24 exploration boreholes and 4 appraisal boreholes (in the case of one borehole drilling was completed in 2010, and tests were carried out in 2011). In total, 52,838 m exploration and appraisal drillings were performed in PGNiG SA's licence areas, of which 49,248 m were performed in Poland and 3,590 m abroad (Denmark and Pakistan).

Out of 23 wells the test results of which are known (19 exploration wells and 4 appraisal wells, including one where drilling ended in 2010, and tests were carried out in 2011), 11 wells were classified as positive (including 9 gas wells and 2 oil and gas wells), and the remaining 11 wells were dry.

Test carried out in 2011 (in new exploration areas where thus far there had been little appraisal) have confirmed the presence of gas in Piaski-3 well (tight gas) in Western Pomerania, and Lubocino-1 (shale gas) in Eastern Pomerania. No commercial gas flow rates were recorded from the Tymowa-1 exploration and appraisal well in the Carpathian Mountains. In 2011, drillings of deep boreholes were carried out in the Carpathian Mountains and Carpathian Foothills: the Kramarzówka-1 borehole was completed, and drilling of the Dukla-1 borehole started.

In 2011, geophysical work was conducted in PGNiG SA's licence areas in the Carpathian Mountains, Carpathian Foothills and Polish Lowlands, as part of which 973 km of 2D seismic data and 843 sq km of 3D seismic data was acquired. Also, 516 km of 2D seismic surveys were carried out abroad, in the area covered by PGNiG SA's licence in Egypt.

As at December 31st 2011, the Group's recoverable reserves were:
- 91.9 billion cubic metres of natural gas measured as high-methane equivalent,
- 21.1 million tonnes of crude oil.

<u>Joint ventures in Poland</u>

In 2011, PGNiG SA collaborated with other entities in areas covered by licences awarded to PGNiG SA, FX Energy Poland Sp. z o.o., and Aurelian Oil & Gas PLC.

Under licences awarded to PGNiG SA, work continued in the following areas:

- "Płotki" – under the Agreement for Joint Operations dated May 12th 2000; licence interests: PGNiG SA (operator) – 51%, FX Energy Poland Sp. z o.o. – 49%,
- "Płotki" – "PTZ" (the Extended Zaniemyśl Area) – under the Operating Agreement of Mining Users dated October 26th 2005; licence interests: PGNiG SA (operator) – 51%, FX Energy Poland Sp. z o.o. – 24.5%, Calenergy Resources Poland Sp. z o.o. – 24.5%,

- "Poznań" – under the Agreement for Joint Operations dated June 1st 2004; licence interests: PGNiG SA (operator) – 51%, FX Energy Poland Sp. z o.o. – 49%,
- "Bieszczady" – under the Agreement for Joint Operations dated June 1st 2007; licence interests: PGNiG SA (operator) – 51%, Eurogas Polska Sp. z o.o. – 24%, and Energia Bieszczady Sp. z o.o. – 25%
- "Sieraków" – under the Agreement for Joint Operations dated June 22nd 2009; licence interests: PGNiG SA (operator) – 51%, Orlen Upstream Sp. z o.o. – 49%,

Also, production continued from the Roszków field in the "Płotki" area, and from the Zaniemyśl field in the "Płotki" – "PTZ" area.

With respect to the "Poznań" licence area, in 2011 gas production continued from the Środa Wielkopolska field and was launched from the Kromolice and Kromolice S fields. Development of the new Winna Góra gas field also commenced, with the well scheduled to come on stream in 2012. Economic quantities of natural gas were discovered in 2011 from the Lisewo-1k exploration well (Lisewo field). Furthermore, a 4,200 m exploratory borehole was completed in Pławce-2 tight gas deposits. Well testing and fracturing is scheduled for 2012. In 2011, field work related to stage II of the 3D seismic survey was executed in the Żerków-Pleszew area. Data processing commenced, and the process is expected to be completed in 2012.Drilling of the Komorze-3k borehole and commencement of the 3D field seismic surveys in the Mirosław area are also scheduled for 2012.

In 2011, drilling of the Niebieszczany-1 well (depth: 4,219 m) was completed in the "Bieszczady" area, and well tests started. Furthermore, 2D field work was conducted in the Paszowa-Brzegi Dolne area, followed by geological interpretation of the data acquired. Seismic 2D field work commenced in the Jaśliska-Baligród area, and field gravimetric surveys were launched in the Hoczew-Lutowiska area.

In the "Sieraków" area, the Sieraków-5 borehole was drilled. As no hydrocarbon flow was identified in the borehole, analysis was carried out to determine the best location for the Sieraków-2 borehole, scheduled for drilling in 2012.

Under licences awarded to FX Energy Poland Sp. z o.o., work was conducted in the following areas:

- "Warszawa-Południe" (blocks 234, 235, 254, 255, 274N) – under the Agreement for Joint Operations dated May 26th 2011 (which with respect to block 255 replaced the agreement of October 29th 1999); licence interests: FX Energy Poland Sp. z o.o. (operator) – 51%, PGNiG SA – 49%
- "Ostrowiec" (blocks 163 and 164) – under the Agreement for Joint Operations dated February 27th 2009; licence interests: FX Energy Poland Sp. z o.o. (operator) – 51%, PGNiG SA – 49%,
- "Kutno" (blocks 211, 212, 231 and 232) – under the Agreement for Joint Operations dated September 30th 2010; licence interests: FX Energy Poland Sp. z o.o. (operator) – 50%, PGNiG SA – 50%,

In the "Warszawa-Południe" area, Machnatka-2 borehole was drilled within block 254 (depth: 4,500 m). The borehole was abandoned, as no hydrocarbon flow was identified. Analytical work continued for the "Ostrowiec" area. In the "Kutno" area, the drilling of a deep exploration borehole Kutno-2 commenced, with a planned depth of 6,450 m.

Under licences awarded to Aurelian Oil & Gas PLC, work was performed in the following areas:

- "Karpaty Zachodnie" – under the Agreement for Joint Operations dated December 17th 2009, concluded with Energia Karpaty Zachodnie Sp. z o.o. Sp. k. (subsidiary of Aurelian Oil & Gas PLC); licence interests: Energia Karpaty Zachodnie Sp. z o.o. Sp. k. (operator) – 60%, PGNiG SA – 40%

- "Karpaty Wschodnie" – under the Agreement for Joint Operations dated December 17th 2009, concluded with Energia Karpaty Wschodnie Sp. z o.o. Sp. k. (subsidiary of Aurelian Oil & Gas PLC); licence interests: Energia Karpaty Wschodnie Sp. z o.o. Sp. k. (operator) – 80%, PGNiG SA – 20%

In 2011, in the "Karpaty Wschodnie" licence area, 2D seismic data acquisition and data processing was completed for the Mszana area, and a new 2D seismic survey was performed for the Jordanów area.

Exploration abroad

PGNiG SA conducts exploration work in Pakistan under an agreement on hydrocarbon exploration and production in the Kirthar licence area executed between PGNiG SA 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 proportionately to the parties' interests in the licence: PGNiG SA (operator) – 70%, PPL – 30%. In 2011, work was under way on workover of the Hallel-1 borehole. Also, processing and interpretation of 2D and 3D seismic data were completed. Results of the interpretation confirmed the presence of a structure giving rise to accumulation of hydrocarbons (Rehman field). In 2012, test production from Hallel-1 i Rehman-1 wells is to be launched (tight gas).

Since the execution of the agreement on assignment of interests in 2007, PGNiG SA has been engaged in exploration activity in the 1/05 licence area in Denmark. Currently, the licence interests are: PGNiG SA (operator) – 80%, Nordsøfonden – 20%. Drilling of the Felsted-1 exploration well started in 2011. Following well logging performed at the beginning of 2012, no commercial hydrocarbon flow was identified. The well was abandoned. Given the negative results from the exploration well, PGNiG SA decided not to extend the 1/05 licence in Denmark.

In Egypt, PGNiG SA has been conducting exploration work in the Bahariya licence area (Block 3) under an Exploration and Production Sharing Agreement (EPSA) with the government of Egypt of May 17th 2009. The Company holds a 100% interest in the licence. In connection with unstable political situation in Egypt, at the beginning of 2011 the Polish employees of the PGNiG SA Egypt Branch were temporarily withdrawn from the country, which however did not affect the progress of the exploration work. In 2011, field gravimetric surveys and their interpretation were completed. The planned acquisition of 1,600 km of 2D profiles was commenced, of which 516 km were acquired in 2011. Protracting administrative procedures concerning tender approval delayed acquisition of the rest of the 2D seismic data until the following year. Processing of seismic data and drilling work are scheduled for 2012.

2. Production

Natural gas and crude oil production in Poland is conducted by two branches of PGNiG SA: the Zielona Góra Branch and the Sanok Branch. The Zielona Góra Branch produces crude oil and nitrogen-rich natural gas at 22 sites, including 14 gas production facilities and 8 oil and gas production facilities. The Sanok Branch produces high-methane and nitrogen-rich natural gas and crude oil at 46 sites, including 26 gas production facilities and 20 oil and gas and oil production facilities.

In 2011, PGNiG SA produced a total of 4.3 billion cubic meters of natural gas (measured as high-methane gas equivalent). Crude oil production was 455.3 thousand tonnes. The table below presents PGNiG SA's production volumes in 2011:

Production volumes

		Entity	2011	2010
1	Natural gas, including:	million cubic metres*	4,329.4	4,220.4
a	high-methane, including:	million cubic meters	1,616.4	1,605.3
	- Zielona Góra Branch	million cubic meters	0.0	0.0
	- Sanok Branch	million cubic meters	1,616.4	1,605.3
b	nitrogen-rich, including:	million cubic metres*	2,713.0	2,615.1
	- Zielona Góra Branch	million cubic metres*	2,637.2	2,530.9
	- Sanok Branch	million cubic metres*	75.8	84.2
2	Crude oil	thousand tonnes	455.3	487.8
	- Zielona Góra Branch	thousand tonnes	407.3	440.7
	- Sanok Branch	thousand tonnes	48.0	47.1

* Measured as high-methane gas equivalent.

Further fields were brought onstream: the Jeżowe, Nowosielec and Łękawica fields within the Sanok Branch's operating area, as well as the Elżbieciny, Jabłonna, Jabłonna S, Jabłonna W (feeding the Grodzisk Denitriding Plant) and Sławoborze fields within the Zielona Góra's operating area,. Moreover, within the Sanok Branch's operating area, another 15 wells commenced production on already producing fields (Zalesie, Jaśniny, Dzików and Rudka). The total addition to production capacity is estimated at approximately 46 thousand cubic metres of gas per hour (measured as high-methane gas equivalent). Moreover, the Kromolice and Kromolice S fields, with a joint production capacity of approximately 8 thousand cubic meter per hour (measured as high-methane gas equivalent), were brought onstream as part of the cooperation with FX Energy Poland Sp. z o.o.

In 2011, PGNiG SA was engaged in various activities aimed at maintaining the gas and oil output from the currently producing fields. In order to increase hydrocarbon production, 9,846 metres of production drilling was performed. Major remedial treatments were performed on a total of 36 wells whose technical condition prevented their further operation. Of that number, 31 wells flowed hydrocarbons at commercial rates. Of the other five, two wells are used as injectors, while one, which did not flow gas at commercial rates, was abandoned. The other two of the treated wells will be used by the underground gas storage facilities. In 2011 recovery techniques were applied on a total of 71 wells (including intensification initiatives), designed to maintain or improve production capacities of producing wells or to recover operating condition of sub-surface extraction equipment. Recovery techniques were also applied on wells operated by the underground gas storage facilities and on injectors.

Products such as crude condensate, sulphur and propane-butane are obtained through the refining of crude oil. A portion of produced nitrogen-rich gas is further treated into high-methane gas at the Odolanów and Grodzisk Wielkopolski Denitriding Plants. 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. The Elżbieciny, Jabłonna, Jabłonna S and Jabłonna W fields having been brought upstream in May 2011, the Grodzisk Denitriding Plant increased its output to the maximum production capacity.

The table below presents volumes of sales of natural gas (including LNG) directly from fields, and of crude oil and other products to external customers. The key customers for natural gas customers were industrial customers, accounting for 85% of the total sales volume.

Sales structure of key products

		Entity	2011	2010
1	Natural gas, including:	million cubic meters	681.8	673.8
	– high-methane gas	million cubic meters	64.0	53.7
	– nitrogen-rich gas*	million cubic meters	617.8	620.1
2	Crude oil	thousand tonnes	464.6	499.0
3	Condensate	thousand tonnes	2.2	1.9
4	Helium	million cubic meters	3.4	3.1
5	Propane-butane	thousand tonnes	20.7	21.0
6	Nitrogen	thousand kg	535.8	832.2
7	Sulphur	thousand tonnes	23.8	25.2

* Measured as high-methane gas equivalent.

In 2011, PGNiG SA continued to sell crude oil to Rafineria Trzebinia S.A. and TOTSA TOTAL OIL TRADING S.A. under the agreements executed in 2009, and to Rafineria Nafty Jedlicze S.A. under a ten-year contract executed in 2007.

PGNiG SA's foreign customers accounted for 40% of the total volume of crude sales, and for 71% of helium sales. Crude oil was sold to a German refinery (through the Druzhba pipeline), whereas most of the helium volume was sold in liquid form to foreign wholesale customers, who resell the product in European countries.

Underground gas storage facilities

In 2011, the Exploration and Production segment used the working capacities of the Brzeźnica, Strachocina and Swarzów high-methane gas storage facilities, as well as of the Daszewo and Bonikowo nitrogen-rich gas storage facilities. The capacities used to store produced gas are not storage facilities within the meaning of the Polish Energy Law.

In 2011, PGNiG SA completed construction and assembly work connected with the extension of the Strachocina Underground Gas Storage Facility and commenced tests and analyses designed to determine the operating parameters and other characteristics of the facility.

Under the annex of December 29th 2011 to the agreement for additional financing of the Strachocina project (as part of the EU Infrastructure and Environment Operational Programme), the expenditure qualification period was extended until June 30th 2012.The table below presents working capacities of the underground storage facilities used by the Exploration and Production segment as at December 31st 2010 and December 31st 2011.

Working capacities of the underground storage facilities used by the Exploration and Production segment (million cubic metres)

High-methane gas	2011	2010
Brzeźnica (E)	65.0	65.0
Strachocina (E)	150.0	150.0
Swarzów (E)	90.0	90.0
Nitrogen-rich gas		
Daszewo (Ls)	30.0	30.0
Bonikowo (Lw)	200.00	200.00

In November 2011, PGNiG SA provided access to third parties, as from the beginning of the 2012/13 storage year, working capacities of the Brzeźnica, Strachocina and Swarzów Underground Gas Storage Facilities. The access was provided on an intermittent basis, as part of long-term storage services.

3. Planned activities

Exploration in Poland

In 2012, PGNiG SA plans to carry out geophysical work and drillings as part of exploration work in Poland on a few dozen of prospects in the Carpathian Mountains, Carpathian Foothills and the Polish Lowlands. These operations will be carried out by PGNiG SA independently as well as in cooperation with foreign partners. As part of these activities, PGNiG SA intends to implement projects focused on exploring new potential in the area of unconventional reserves (shale oil/gas and tight gas), where little appraisal has so far been made. Further drilling work is scheduled in the Lubocino formation explored by the drilling of the Lubocino-1 research borehole. The Company intends to start drilling the Opalino-2, Lubocino-2h, Miłowo-1 and Mirowo-2 wells (Pomerania), as well as the Lubycza Królewska well (Lublin region). In the Carpathian Mountains and Carpathian Foothills, the drilling of the deep Dukla-1 well is to be completed, while the Kramarzówka1 well will undergo testing.

Exploration abroad

In 2012, PGNiG SA will continue exploration work in Egypt. In Denmark, given the negative results from the Felsted-1 exploration well, PGNiG SA decided not to extend the 1/05 licence. In Pakistan, test production from the Hallel-1 and Rehman-1 wells will be launched.

Natural gas production

PGNiG SA is implementing an investment programme aimed at increasing, in a long term, its 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 plans for 2012 assume the annual natural gas production volume of approximately 4.5 billion cubic meters of high-methane gas equivalent with a calorific value of 39.5MJ per cubic meter, of which approximately 4.4 billion cubic meters will be produced in Poland and 0.1 billion cubic metres in Pakistan.

2012 will see new wells put on stream in the existing fields (Bogdaj-Uciechów, Jarocin, Rudka and Pruchnik), and launch of production from new fields (Góra Ropczycka, Rylowa-Rajsko and Lubliniec), with total production capacities of approximately 18.5 thousand cubic metres per hour.

Crude oil production

In 2012, PGNiG SA plans to produce 480.0 thousand tonnes of crude oil from domestic fields. Three new wells are to be hooked up in the Barnówko-Mostno-Buszewo (BMB) field in Poland.

4. Risks related to Exploration And Production

Resource discoveries and estimates

The main risk inherent in exploration activity is the risk of failure to discover reserves, i.e. the exploration risk. This means that not all the identified potential deposit sites have deposits of hydrocarbons which can qualify as an accumulation. Whether or not a sufficient accumulation exists depends on a number of geological factors. Furthermore, the actual quantity and quality of the accumulated hydrocarbons may differ from estimates. When the results of successful exploration activity, in the form of new reserves, do not offset the production from the existing reserves, PGNiG SA’s recoverable reserves will decrease pro rata to the current production volumes.

The reserves estimates and production projections may be erroneous due to imperfections inherent in the equipment and technology, which affect the quality of the acquired information concerning the geological factors and the characteristics of the deposit site. 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 the commencement 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 starts. Each downgrade of the size of the reserves or production quantities may lead to a lower revenue and adversely affect PGNiG SA’s financial performance.

Exploration for unconventional gas

The risk associated with exploration for unconventional gas in Poland relates to the lack of confirmed presence of shale gas and tight gas. Furthermore, even if existence of in-place petroleum is confirmed, its production may prove uneconomic due to insufficient gas recovery and high investment expenditure necessary on drillings and construction of production infrastructure. Another material factor is connected with difficult access to unconventional gas prospects given the environmental regulations and the necessity to obtain the landowners’ consent for access to the area.

Competition

Both on the Polish market and abroad there is a risk of competition from other companies in the area of acquisition of licences for exploration for and appraisal of hydrocarbon deposits. Certain competitors of PGNiG SA, especially those active globally, enjoy strong market positions and have financial resources larger than those of PGNiG SA. 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 PGNiG SA could offer given its financial and human resources. This competitive advantage is particularly important on the international market.

Delayed work

Under the applicable Polish legal regulations, obtaining a licence for exploration for and appraisal of crude oil and natural gas deposits lasts from one to one and a half years. On foreign markets, such procedures may take even two years from the time that the winning bid is awarded in a tender for licence until the relevant contract is ratified. Moreover, prior to the commencement of field work, the Company is required to make a number of arrangements, including obtaining formal and legal permits and approvals for entering the area, meeting environmental protection-related requirements and, in some cases, requirements related to protection of archaeological sites, and abiding by the regulations governing tenders held to select a contractor, which delays execution of an agreement with a contractor by another few months. In addition, frequently the waiting time for customs clearance of imported equipment is very long. These factors create the risk of delays in the start of exploration work.

Formal and legal hurdles beyond PGNiG SA's control include:
- local governments’ failure to approve local zoning plans or amendments to those already approved;
- obstacles in incorporating investment projects into the local zoning plans;
- need to obtain and comply with administrative or other formal and legal decisions, including environmental decisions or building permits;
- amendments to the current investment project;
- obstacles in obtaining permission from land owners to enter the site.

These factors significantly delay implementation of investment projects and commencement of on-site construction work. Concurrently, PGNiG SA’s obligation to comply with the Public Procurement Law frequently prolongs the tender procedure. Notices of appeal and complaints submitted by bidders lead to lengthy court proceedings and, consequently, to delays in implementing an entire investment project. A protracted investment process exacerbates the risk related to estimation of capital expenditure.

Cost of exploration

Exploratory work is capital intensive, given the 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 an increase in the cost of exploratory work. Moreover, profitability of foreign exploration projects to a significant extent depends on the prices of oil derivative products and on exchange rates. In 2011, PGNiG SA introduced the Daily Rate system into the drilling contractors selection procedure, which is expected to reduce the costs of drilling services.

Safety, environmental protection and health regulations

Ensuring compliance with environmental laws in Poland and abroad may significantly increase PGNiG SA’s operating expenses. Currently, PGNiG SA 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. of June 27th 2005, No. 113, item 954) rendered the regulations governing the execution of projects which might affect the 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. The tendency to tighten up the environmental protection regulations is seen also in other countries where PGNiG SA conducts exploration activity.

Qualified personnel

The presence of foreign companies on the Polish market has intensified competition for highly qualified employees with extensive professional experience. This risk of losing experienced personnel is especially high with respect to oil and gas exploration professionals. In countries where PGNiG SA operates, highly qualified staff is difficult to recruit.

Unpredictable events

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

Changes in laws and regulations

The laws and regulations in some countries change frequently and unexpectedly, causing problems to entities involved in exploration activity. This problem may be particularly acute in countries where changes in law depend on decisions made by authoritarian governments.

Political and economic situation

In some countries where PGNiG SA conducts exploration activity there is a risk of armed conflicts or terrorist attacks, which may lead to a limitation, suspension or discontinuation of the exploration and production activities.

In some regions where PGNiG SA is present there is a risk of social and political unrest. Changes of governments may bring to a halt licensing proceedings before state administration authorities. Additionally, these countries are at risk of internal conflicts and social unrest caused by poor social and demographic conditions. The risks specified above may lead to a limitation, suspension or discontinuation of PGNiG SA's activities.

In certain countries, operations of exploration companies may be hindered by the lack of adequate infrastructure, which may be an obstacle in transporting equipment, personnel and materials to the sites. Problems may also arise in providing supplies and ensuring appropriate health care. These risks may lead to a limitation or suspension of the Company's exploration activities.

Chapter VI: Trade and Storage

The segment sells both imported and domestically-produced natural gas. Imported natural gas is purchased chiefly from markets east of Poland. Sale of natural gas through the distribution and transmission network is regulated by the Polish Energy Law, and gas prices are determined based on tariffs approved by the President of the Energy Regulatory Office. The segment also uses three underground gas storage facilities, located in Mogilno, Wierzchowice and Husów.

1. Gas purchases

In 2011, PGNiG SA imported gas and, to a limited extent, purchased the fuel from domestic suppliers. PGNiG SA imported natural gas mainly under the agreements and contracts specified below, i.e. the long-term contract with Gazprom Export and medium-term gas supply agreements with VNG-Verbundnetz Gas AG:

- Contract with Gazprom Export for sales of natural gas to the Republic of Poland, dated September 25th 1996, which will remain in force until 2022;
- Agreement with VNG-Verbundnetz Gas AG for sales of the Lasów natural gas, dated August 17th 2006, which will remain in force until October 1st 2016;
- Agreement with VNG-Verbundnetz Gas AG for sales of the Lasów 2008 natural gas, dated September 29th 2008, in force until October 1st 2011.

The table below presents the structure of the Group's purchases of natural gas, measured as high-methane gas equivalent.

Structure of natural gas purchases by supply sources (million cubic metres)

	2011	%	2010	%
Imports, including:	10,915.3	99.0%	10,066.4	99.1%
– Gazprom Export	9,335.5	85.5%	9,028.4	89.7%
– VNG AG	716.0	6.6%	890.8	8.8%
– Other foreign suppliers	863.8	7.9%	147.2	1.5%
Domestic suppliers	112.3	1.0%	96.1	0.9%
Total	11,027.6	100.0%	10,162.5	100.0%

On January 1st 2011, NAK Naftogaz Ukrainy suspended gas deliveries via the Zosin cross-border point (near Hrubieszów) on the Polish-Ukrainian border, where gas is supplied to Poland under a gas supply agreement of October 26th 2004. As at the date of this report, NAK Naftogaz Ukrainy has not resumed gas deliveries to the Hrubieszów area. PGNiG SA is looking for other suppliers who could guarantee gas deliveries to the Zosin terminal. Despite the suspension of gas supplies from Ukraine, the Hrubieszów area has been receiving sufficient gas supplies to meet the local demand.

New agreements

On March 21st 2011, PGNiG SA and Gazprom Export executed an annex to the contract of September 25th 1996 providing for sales of natural gas to the Republic of Poland. The parties agreed on an option to increase the daily offtake at the Vysokoye cross-border point to 15 million cubic metres, with the annual contracted volumes remaining unchanged.

On May 13th 2011, PGNiG SA and Vitol SA concluded an Individual Agreement for natural gas supplies to a cross-border terminal on the Polish-Czech border in the Cieszyn area. Under the agreement, approximately 550 million cubic metres of gas per year will be delivered in the period from October 1st 2011 to October 1st 2014.The gas will be supplied via a newly built interconnector, which has connected the gas systems of Poland and the Czech Republic.

On May 13th 2011, PGNiG SA and VNG-Verbundnetz Gas AG signed an Individual Agreement for summer gas supplies to the Lasów cross-border terminal. Under this agreement, gas was supplied in the period from May 17th to July 3rd 2011.

On June 30th 2011, PGNiG SA and VNG-Verbundnetz Gas AG executed an Individual Agreement for summer gas supplies to the Lasów cross-border terminal. Under the agreement, gas was supplied in the period from July 3rd to September 30th 2011.

In 2011, PGNiG SA reserved transmission capacity in the German transmission system in order to transport the volume of gas purchased on the VTP Gaspool platform. The transmission capacities were reserved for the period October 1st 2011–September 30th 2016 (Lasów cross-border terminal) and for the period October 1st 2011–October 1st 2014 (Gubin cross-border terminal). In September 2011, PGNiG SA executed three short-term EFET (European Federation of Energy Traders) standard contracts at the VTP Gaspool platform for delivery of small amounts of natural gas.

Also, in order to transport the volumes of gas purchased on the German market (at the VTP Gaspool platform), the Company and OGP GAZ-SYSTEM S.A. executed a short-term agreement for the provision of virtual reverse flow services on the Yamal gas pipeline in the period from November 1st 2011 to January 1st 2012. The gas was delivered on the basis of a series of separate transactions executed through PGNiG Sales & Trading GmbH.

2. Gas sales

In 2011, PGNiG SA signed comprehensive agreements for supply of gas fuel, both from the transmission system and from the distribution system, to 90.1 thousand new customers.

On March 11th 2011, a comprehensive agreement for the supply of gas fuel was executed signed with Elektrociepłownia Stalowa Wola S.A. The fuel will be used to fire a CCGT unit. The planned annual offtake is approximately 540 million cubic metres. The agreement was concluded for 14 years, starting from the launch of supplies. Performance of the agreement will commence upon fulfilment of certain conditions precedent. The value of the agreement throughout its term is estimated at approximately PLN 9.7bn.

In the period June 27th–29th 2011, PGNiG SA executed six agreements with Gas Distribution Companies, including:

- Dolnośląska Spółka Gazownictwa Sp. z o.o.
- Górnośląska Spółka Gazownictwa Sp. z o.o.
- Karpacka Spółka Gazownictwa Sp. z o.o.
- Mazowiecka Spółka Gazownictwa Sp. z o.o.
- Pomorska Spółka Gazownictwa Sp. z o.o.
- Wielkopolska Spółka Gazownictwa Sp. z o.o.

Under the agreements, the Gas Distribution Companies will provide gas fuel distribution services to PGNiG SA. The agreements remain in effect from June 29th 2011 to June 28th 2015. The estimated aggregate value of the agreements over their entire term is approximately PLN 14bn.

On November 29th 2011, PGNiG SA and Grupa LOTOS S.A. executed an annex to the comprehensive gas fuel supply agreement of June 16th 2010. Under the annex, the starting date of gas fuel supplies to Grupa LOTOS S.A. was changed from December 16th 2011 to April 30th 2012. The annex also changes the planned, target annual volume of natural gas deliveries from 447 million cubic metres to 585 million cubic metres. The estimated value of the agreement over a period of five years is to approximately PLN 3.2bn.

The key products sold by the Trade and Storage segment are high-methane gas and nitrogen-rich gas. In 2011, sales of natural gas remained flat year on year. PGNiG SA sold gas chiefly on the Polish market. The structure of the Trade and Storage segment's sales in 2011 is presented in the table below.

Sales structure of key products

		Entity	2011	2010
1	Natural gas, including:	million cubic meters	13,699.2	13,743.0
	– high-methane gas	million cubic meters	13,204.6	13,221.9
	– nitrogen-rich gas*	million cubic meters	494.6	521.1
2	Propane-butane	thousand tonnes	1.9	2.1

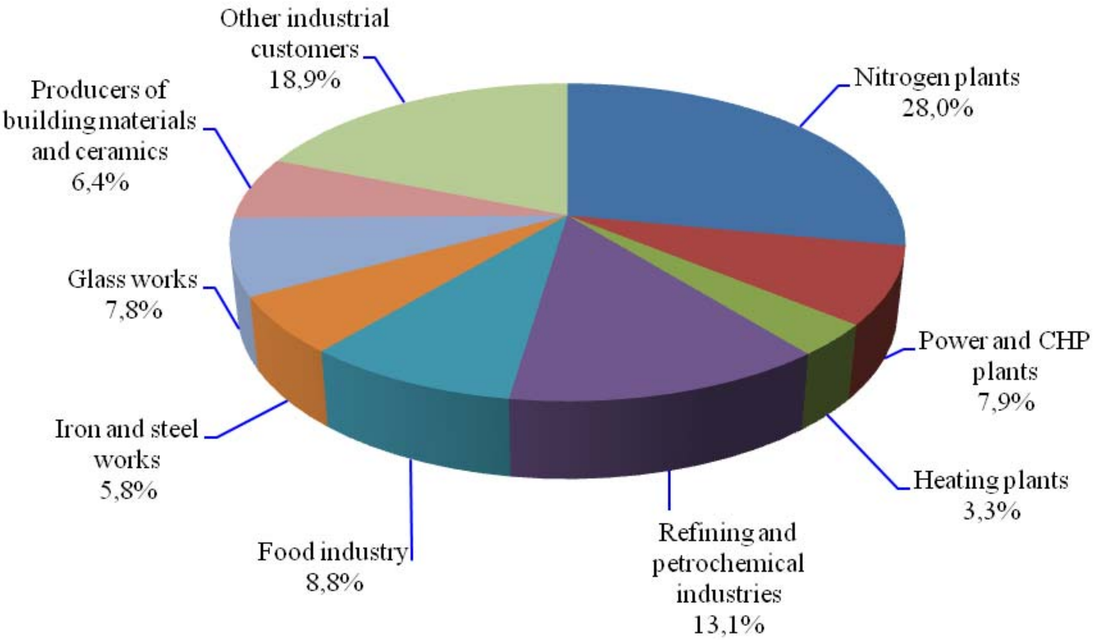
* Measured as high-methane gas equivalent.

The Group's key customers included companies from the chemical, petrochemical and metallurgical sectors, as well as households. Households made up the largest group of customers purchasing natural gas, accounting for 97% of the entire customer base (approximately 6.5m). Their share in the total sales volume went down by approximately 9% year on year. On the other hand, sales of natural gas to industrial customers, representing 60% of the total sales volume, grew by 441.1 million cubic metres (approximately 6%). The table below presents the structure of sales of natural gas (measured as high-methane gas equivalent) by customer groups.

Sales of natural gas through the national grid (million cubic meters)

	2011	%	2010	%
Industrial customers	8,252.4	60.3%	7,811.3	56.8%
Trade and services	1,468.5	10.7%	1,574.3	11.5%
Households	3,730.1	27.2%	4,095.8	29.8%
Wholesale customers	221.5	1.6%	217.7	1.6%
Exports	26.7	0.2%	43.9	0.3%
Total	13,699.2	100.0%	13,743.0	100.0%

Structure of sales of natural gas to industrial customers in 2011



In 2011, PGNiG SA and Mazowiecka Spółka Gazownictwa Sp. z o.o. completed network switch-over from propane-butane-air to high-methane gas in the town of Pisz in the Olsztyn province.

PGNiG SA and ZRUG Sp. z o.o. of Poznań completed construction of a gas network in the Rakoniewice municipality. The project involved construction of a 75km medium-pressure gas pipeline. Completion of this project will contribute to an increase in the number of new connections and in the volume of gas sold.

In 2011, PGNiG SA launched a gas distribution project consisting in LNG distribution of gas fuel to Ełk and Olecko. This project is a part of a initiative to switch Pisz, Ełk, Suwałki and Olecko to high-methane gas (the PESO project). Construction of gas distribution installations under the project is to be completed in 2013.

3. Storage

The Trade and Storage segment uses for its own needs the working capacities of the Wierzchowice Underground Gas Storage Facility, the Husów Underground Gas Storage Facility and the Mogilno Underground Gas Storage Cavern Facility. A part of the working capacity of the Mogilno facility, which is not a storage facility within the meaning of the Polish Energy Law, was made available to OGP GAZ-SYSTEM S.A.

Short-term peak fluctuations in customer demand for natural gas are balanced out with the supplies from the Mogilno Underground Gas Storage Cavern Facility, where gas is stored in worked-out. The capacities of the Wierzchowice and Husów Underground Gas Storage 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 contracts for imports, to safeguard the continuity and security of natural gas supplies and to meet the obligations under sales agreements providing for the delivery of natural gas to customers' premises.

In addition, the capacities of the Wierzchowice, Husów and Mogilno facilities are used by the Group 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.

Since 2009, PGNiG SA has the status of Storage System Operator. In March 2011, PGNiG SA applied to the President of the Energy Regulatory Office requesting the appointment of Operator Systemu Magazynowania Sp. z o.o. as the Storage System Operator for gas fuels and the granting of a licence for storage of gas fuels in storage facilities. These steps were taken with a view to meeting the obligations under Regulation (EC) No. 715/2009 of the European Parliament and of the Council of July 13th 2009 on conditions for access to the natural gas transmission networks and repealing Regulation (EC) No. 1775/2005.As at the date of this report, the proceedings were pending.

Detailed terms of providing gas fuel storage services (working capacity, injection capacity, withdrawal capacity) and sale of storage services are laid down in the “Rules of Provision of Storage Services”. The current version of "Rules of Provision of Storage Services" are available at the Storage System Operator's website.

In 2011, PGNiG SA continued work related to the construction of four caverns in the Mogilno Underground Gas Storage Cavern Facility and the surface part of the Wierzchowice Underground Gas Storage Facility. The Company also commenced construction of the surface part of a new high-methane gas storage facility, i.e. the Kosakowo Underground Gas Storage Cavern Facility.

Under an annex of December 29th 2011 to the agreement for co-financing of the Wierzchowice Underground Gas Storage Facility project (as part of the EU Infrastructure and Environment Operational Programme), the period for qualifying the project-related expenditure as eligible was extended until March 31st 2014. The agreement for partial financing of the Mogilno Underground Cavern Gas Storage Facility was terminated, because the European Commission did not approve the expenditure submitted by PGNiG SA for partial financing as qualifying. The table below presents working capacities of the underground storage facilities as at December 31st 2010 and December 31st 2011.

Working capacities of the storage facilities in the Trade and Storage segment (million cubic meters)

	2011	2010
Husów	350.0	350.0
Mogilno	377.9	377.9
Wierzchowice	575.0	575.0

In November 2011, PGNiG SA made available a total of 751.5 million cubic metres of working storage capacity (of both the Storage and Trade segment and the Exploration and Production segment) for third party access, provided on an intermittent basis, of which 730 million cubic metres was made available under long-term agreements effective as of the beginning of the 2012/2013 storage year, and 21.5 million cubic metres under short-term agreements in the 2011/2012 storage year.

Until the end of 2011, PGNiG SA made available a total of 1,378.5 million cubic metres of working storage capacity for third party access, provided on a continuous or intermittent basis, of which 1,357 million cubic metres was made available under long-term agreements and 21.5 million cubic metres under short-term agreements.

4. Planned activities

Gas supplies

In order to reduce gas acquisition costs in the coming years, PGNiG SA executed an agreement with OGP GAZ-SYSTEM S.A. for the provision of virtual reverse services on the Yamal gas pipeline from January 1st 2012 to December 31st 2015, on an intermittent basis. It will enable the Company to purchase gas at the VTP Gaspool platform (virtual trading point) and provide a sufficient level of gas supplies to Poland.

Storage

In 2012, PGNiG SA will continue work on extending the Mogilno Underground Gas Storage Cavern Facility and the Wierzchowice Underground Gas Storage Facility. Completion of the surface part of the Wierzchowice Underground Gas Storage Facility has been rescheduled for 2012. Moreover, the Company will continue construction of a new high-methane gas storage facility, i.e. the Kosakowo Underground Gas Storage Cavern Facility. In the future, the Company intends to make available to third parties the extended storage capacities in Strachocina, Mogilno and Wierzchowice facilities.

5. Risks related to Trade and Storage

Requirement to diversify supplies of imported gas

On December 16th 2010, the President of the Energy Regulatory Office imposed a PLN 2m fine on PGNiG SA for breaching the terms and conditions of its licence for international trade in natural gas, by failing to comply with the requirement to diversify supplies of imported gas in 2007 and 2008. The maximum share of gas imported from one country in total gas imports in a given year is determined in the Council of Ministers’ Regulation of October 24th 2000 on the minimum level of diversification of foreign sources of gas supplies. On January 4th 2011, PGNiG SA filed an appeal against the decision imposing a fine through the agency of the President of the Energy Regulatory Office to the Regional Court of Warsaw. The Company challenged in full the decision of the President of the Energy Regulatory Office, citing, among other things, breach of the Constitution, erroneous interpretation and improper application of the Energy Law. Moreover, in order to avoid similar situations in the future, PGNiG SA submitted an inquiry to the Constitutional Court concerning the compliance of the Council of Ministers’ Regulation of October 24th 2000 on the minimum level of diversification of foreign sources of gas supplies with the Polish Constitution.

If no changes are made to the Regulation, the President of the Energy Regulatory Office may keep on imposing fines on the Company for failing to comply with the diversification requirement until gas starts to be delivered to the Company from other sources (e.g. through the LNG terminal).

Deregulation of gas prices for customers

PGNiG SA is the largest supplier of natural gas in Poland. Its share in the gas market is estimated at approximately 98%, and the remaining 2% is represented by suppliers from outside the PGNiG Group which usually purchase gas from PGNiG SA. However, in 2012–2013, important changes are expected to take place on the natural gas market and in the legal environment. Deregulation of gas prices for institutional customers is planned for January 1st 2013, followed by deregulation of gas prices for households (in 2–3 years time). Additionally, the Gas Law and the new Energy Law are planned to be adopted in 2012. As a result of introducing the planned changes, the Company’s share in the natural gas sales volume may significantly fall to the benefit of the existing or new gas trading entities. On the other hand, following the deregulation process, gas prices will be chiefly market-driven.

Storage

Pursuant to the Act on Mandatory Stocks, as of October 1st 2012, the volume of mandatory stocks must be increased from 20 to 30 days of average annual imports. As a result, there is a risk that the Company will not be able to meet its obligations under the gas sales agreements, given that significant storage capacities which will have to be used for storage of the increased mandatory stocks.

Chapter VII: Other Activities

PGNiG SA's organisational unit classified in the "Other Activities" segment is the Central Measurement and Testing Laboratory Branch. The Branch provides services ensuring accurate and reliable measurements of natural gas, comprising in particular calibration of measurement devices, attestation of gas meters and gas volume converters, gas quality testing, testing of new gas equipment as well as measurement and analytical supervision over process analyser systems and equipment installed in transmission and distribution networks, and in gas storage facilities. The Branch also offers advisory services, issues opinions, prepares expert reports and carries out validations and measurement supervision of field quality-testing laboratories.

In 2011, the Branch's main areas of activity included:

- metrological inspections of measurement systems on the Yamal-Europe transit gas pipeline (Polish section),
- metrological inspections and supervision of measurement stations at Polish borders (Wysokoje, Tietierowka and Cieszyn)
- metrological inspections of measurement systems at industrial customers' metering stations (33 facilities),
- checking natural gas measurement systems for the purposes of assessment of CO_2 emissions by large industrial emitters,
- measurement oversight over the process analyser systems for the evaluation of gas quality in the transmission and distribution networks, at production sites and in storage facilities,
- validations and measurement supervision of the field quality-testing laboratories.

The Branch released a number of technical papers, which included reports on selection of the upgraded measurement system for the Mogilno Underground Gas Storage Cavern, performance of rotary gas meters in variable gas flow, use of ultrasonic gas meters in diverse measurement conditions, gas fuel settlements, and new applications of gas fuel, in particular at households and small enterprises.

The Branch provided its services mainly to EUROPOL GAZ S.A., OGP GAZ-SYSTEM S.A. and the companies of the PGNiG Group.

<u>Planned activities</u>

The Branch intends to maintain and strengthen its position as the leading laboratory in the area of metrologic control of measurement systems and devices, attestation of all types of gas meters and gas volume converters, quality assessment of natural gases of all types (E and L) and forms (NG, LNG, CNG) and biogas, as well as evaluation of measurement and process analyser systems used to estimate CO_2 emissions. The Branch also intends to develop services related to measurement and settlement of LNG shipped by sea.

The Branch plans to expand research on gas volume converters and establish itself as a leading research centre in the area of quality assessment of natural gases and biogas.

Risks

Liberalisation of the gas market poses a risk that other Polish and foreign laboratories will enter the domestic market of natural gas measurement and analysis services (competition risk). In 2011, the number of accredited laboratories in Poland providing services similar to the ones offered by the Central Measurement and Testing Laboratory continued to grow.

Chapter VIII: Investments

In 2011, PGNiG SA's capital expenditure on property, plant and equipment and intangible assets amounted to PLN 2,089.5m. The table below presents the expenditure in the individual segments.

Capital expenditure (PLNm)

	2011
Exploration and Production	1,544.1
Trade and Storage	545.1
Other Activities	0.3
Total	2,089.5

Below are described the key investment projects implemented by PGNiG SA.

Exploration

In the area of exploration, capital expenditure of PLN 510.3m was incurred mainly on 11 wells drilled with positive results, wells the drilling of which is still under way, and 12 dry wells, where the related expenditure was charged to expenses in the current reporting period.

Lubiatów-Międzychód-Grotów project

The objective of the project is to develop the Lubiatów-Międzychód-Grotów ("LMG") oil and gas field and to facilitate the transport, storage and sale of crude oil, natural gas, liquid sulphur and propane-butane from the LMG Oil and Gas Production Facility. The LMG project involves:

- construction of the LMG Central Facility to serve as a hub for collection, distribution and treatment of reservoir fluids
- construction of the Dispatch Terminal in Wierzbno (sub-project completed in previous years)
- construction of a gas pipeline to the Grodzisk Denitriding Plant to provide for transmission of surplus gas from the LMG oil and gas production facility to the Grodzisk Denitriding Plant.

In 2011, construction of the LMG Central Facility was underway. The total project value is estimated at approximately PLN 1.6bn. The expenditure incurred in 2011 amounted to PLN 435.5m.

Grodzisk project

The objective of this project is to ensure that gas produced from nitrogen-rich gas fields is of commercial garde; to this end, the gas must be processed to achieve the parameters of high-methane gas (cryogenic nitrogen removal). The Grodzisk project involved development of the Paproć W, Wielichowo and Ruchocice fields, development of the Nowy Tomyśl-2k well, modernisation of the Paproć Gas Production Facility, construction of the gas pipeline from Przyłęk to the Paproć Gas Production Facility, and construction of the Grodzisk Denitriding Plant.

In 2011, extension of Paproć-Cicha Góra Gas Production Facility and development of Elżbieciny and Jabłonna wells marked completion of the entire project. Total expenditure on the Grodzisk project was PLN 458m.

High-pressure gas pipeline from Kłodawa mixing plant to LMG oil and gas production facility

The project involves construction of a high-pressure gas pipeline from Kłodawa Mixing Plant to LMG oil and gas production facility, which will connect two production areas and enable transmission of natural gas from the Dębno region, through Kłodawa mixing plant and LMG oil and gas production facility to the Grodzisk mixing and denitriding plant. The gas pipeline will also be used as a storage facility to cover temporary shortages of commercial-grade gas. Construction of the pipeline continued in 2011. The total cost of the project is estimated at approximately PLN 110.7m. In 2011, the incurred expenditure was PLN 80.4m.

Gas pipeline to KGHM

The project involves construction of a high-pressure gas pipeline and optic-fibre cable with infrastructure, from the Kościan gas production facility to KGHM Polkowice/Żukowice; the pipeline will be used to sell natural directly to KGHM Polkowice/Żukowice. Construction of the pipeline continued in 2011. The total cost of the project is estimated at approximately PLN 220m. In 2011, the expenditure was PLN 31.5m.

Other investment projects in the Production segment

Other investment projects involved the development of gas reserves (including already producing fields), projects executed in order to sustain or restore hydrocarbon production rates, and projects related to the operation of the hydrocarbon production area. The key investment projects included:

- modernisation and extension of the existing gas production facilities
- development of the Rylowa-Rajsko, Góra Ropczycka and Rudka gas fields
- completion of the Zalesie gas field development
- completion of the Sarzyna well development
- commencement of Radlin and Wola Różaniecka well drilling.

Underground gas storage facilities (Exploration and Production)

The Exploration and Production segment's expenditure on the gas storage facilities amounted to PLN 90.1m.In July 2011, construction and assembly works related to the extension of Strachocina Underground Gas Storage Facility were completed. Total expenditure on the Strachocina Underground Gas Storage Facility amounted to PLN 424m.

Underground gas storage facilities (Trade and Storage)

Capital expenditure on underground gas storage facilities in the Trade and Storage segment amounted to PLN 430.7m and related to:

- continuation of construction of the surface part of the Wierzchowice Underground Gas Storage Facility
- commencement of construction of the surface part of the Kosakowo Underground Gas Storage Facility and continued leaching work in the caverns
- continuation of construction of four caverns in the Mogilno Underground Gas Storage Cavern Facility.

Chapter IX: Environmental protection

Well abandonment

Pursuant to the Polish Geological and Mining Law, PGNiG SA is required to properly abandon worked-out mining caverns, eliminate the danger, repair any damage caused by mining activities, 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 to water courses. Furthermore, if gas wells remained unplugged, there would be a risk that escaping gas could accumulate inside, posing a fire hazard. In 2011, a total of 11 wells (including one well where there were no commercial gas flows following a workover) and 11 mining pits were abandoned.

Carbon credit trading system

In 2011, the Zielona Góra Branch and the Odolanów Branch, as well as the Mogilno Underground Gas Storage Cavern Facility, were covered by the carbon dioxide emission trading scheme (ETS). Emission from those installations amounted to 91,098 Mg CO_2. In 2011, an initial review was carried out to qualify Wierzchowice Underground Gas Storage Facility for the carbon dioxide emission trading scheme.

Methane emissions

In 2011, detailed recording of methane emissions from the gas distribution system commenced. Its purpose is to estimate the size of methane emissions from particular components of the system, review the emission indicators applied to date, and develop uniform indicators and calculation methods for methane emissions. Standardised and reliable methane emission indicators will help reduce the cost of environmental fees and charges.

Land reclamation and non-productive asset surveying

Pursuant to the Environmental Protection Law, PGNiG SA conducts diagnosis tests and surveys and land reclamation work in the areas polluted in the course of past activities with a view to restoring them to the condition required under the environmental quality standards. In 2011, supplementary tests and surveys concerning properties located in Kargowa, Zabrze, Łabiszyn and Międzylesie (with a total area of 15,500 sq m), as well as land reclamation work on the properties in Pyrzyce and Koźmin Wielkopolski (with a total area of 9,000 sq m), were completed. In addition, land reclamation work on the properties in Karkowa and Radków commenced in 2011.

Exploration for and appraisal of unconventional hydrocarbons

In 2011, PGNiG SA commenced research to identify types and scale of threats that may be brought by exploration and appraisal work involving high water consumption and use of chemicals in the hydraulic fracturing of shale, as well as large amount of waste generated by the process

Chapter X: Other information

Distribution of the 2010 profit

On April 20th 2011, the Annual General Meeting of PGNiG SA adopted a resolution to distribute the 2010 net profit of PLN 1,702.1m in the following manner:

- PLN 921.6m was allocated for contribution to the Company's statutory reserve funds
- PLN 708.0m was allocated for dividend payment (PLN 0.12 per share), of which up to PLN 30.1m will be transferred to the State Treasury as non-cash dividend in the form of transmission system components, and as cash dividend (the difference between the value of dividend due given the number of shares held by the State Treasury and the final value of the non-cash dividend)
- PLN 9.1m was allocated for contribution to the Company's social benefits fund
- PLN 58.4m was allocated for awards (bonuses) for the Company's employees
- PLN 5.0m was allocated for contribution to the Central Restructuring Fund capital reserve.

In addition, retained earnings of PLN 76.5m was allocated for contribution to the Company's statutory reserve funds.

The Annual General Meeting of PGNiG SA set July 20th 2011 as the dividend record date and October 6th 2011 as the dividend payment date.

Discharge granted to Management Board and Supervisory Board members in respect of their duties

On April 20th 2011, the Annual General Meeting of PGNiG SA approved the financial statements and the Director's Report on the operations of PGNiG SA, as well as the consolidated financial statements and the Director's Report on the operations of the PGNiG Group, and granted discharge to members of the Management and Supervisory Boards of PGNiG SA in respect of their performance of duties in the financial year 2010.

Acquisition of shares in Vattenfall Heat Poland S.A.

On August 23rd 2011, PGNiG SPV 1 Sp. z o.o., a wholly-owned subsidiary of PGNiG SA, and Vattenfall AB executed a preliminary share purchase agreement. The agreement provides for the purchase of 24,591,544 shares in Vattenfall Heat Poland S.A., representing over 99.8% of the company's share capital, which carry voting rights representing more than 99.8% of the total voting rights at the General Meeting of Vattenfall Heat Poland S.A. The shares are registered shares with a par value PLN 10.00 per share and a total par value of PLN 245,915,440.00. The transaction value as at the date of the agreement was approximately PLN 2.96bn, which reflected enterprise value of approximately PLN 3.5bn.

To finance the acquisition of Vattenfall Heat Poland S.A. and all related transaction costs, PGNiG SA advanced to PGNiG SPV 1 Sp. z o.o. a loan of up to PLN 3.78bn, to be repaid by December 31st 2012.

On December 7th 2011, PGNiG SA obtained clearance from UOKiK for a business combination involving the purchase of shares in Vattenfall Heat Poland S.A. by PGNiG SPV 1 Sp. z o.o., and thus the condition precedent to the final share purchase agreement was satisfied.

On January 11th 2012, PGNiG SPV 1 Sp. z o.o. signed the final agreement with Vattenfall AB to purchase 24,591,544 shares in Vattenfall Heat Poland S.A. The purchase price as at the date of the agreement was PLN 3.02bn.

Acquisition of shares in Vattenfall Heat Poland S.A. represents an implementation of one of the PGNiG Group's strategic goals in the power sector. The core business of Vattenfall Heat Poland S.A. is co-generation of heat and electricity. The installed capacity of the company's generating units is 4.8 GW of thermal power and 1 GW of electrical power, which satisfies approximately 75% of the heat demand on the Warsaw market. The company's main customer is SPEC S.A.

Construction of a CCGT Unit in Stalowa Wola

Under the project "Construction of a CCGT Unit in Stalowa Wola", on March 11th 2011, the following three material agreements were signed:

- Agreement on the operation of the SPV of Elektrociepłownia Stalowa Wola S.A., concluded between PGNiG SA, PGNiG Energia S.A., TAURON Polska Energia S.A., Elektrownia Stalowa Wola S.A. and Elektrociepłownia Stalowa Wola S.A. The agreement replaced the agreement of May 7th 2010 on the preparation and implementation of the investment project providing for the construction of a CCGT unit in Stalowa Wola (with annex);
- Comprehensive agreement for supplies of gas fuel to Elektrociepłownia Stalowa Wola S.A., concluded between PGNiG SA and Elektrociepłownia Stalowa Wola S.A.;
- Agreement for sale of electricity by Elektrociepłownia Stalowa Wola S.A. to PGNiG Energia S.A. and TAURON Polska Energia S.A.

Legal actions against PI GAZOTECH Sp. z o.o.

Proceedings concerning PGNiG SA's action against PI GAZOTECH Sp. z o.o. to rescind or declare invalidity of resolutions by the General Meeting of PI GAZOTECH Sp. z o.o., dated April 23rd 2004, including the resolution obliging PGNiG SA to pay additional contributions in the amount of PLN 52m, were held in turn before the Regional Court of Warsaw, the Warsaw Court of Appeals and the Supreme Court. On June 25th 2010, the Regional Court granted PGNiG SA's claims and declared the resolution concerning share redemption and the resolution concerning the additional contributions as invalid. On November 12th 2010, PI GAZOTECH Sp. z o.o. filed an appeal with the Regional Court, along with a petition to be exempt from court fees. On June 4th 2011, PGNiG SA filed a response to the above appeal with the Warsaw Court of Appeals. On December 14th 2011, the Court of Appeals dismissed PI GAZOTECH Sp. z o.o.'s appeal against the Regional Court's decision.

Proceedings based on PGNiG SA's action against PI GAZOTECH Sp. z o.o. to rescind or declare invalidity of the resolution of the General Meeting of PI GAZOTECH Sp. z o.o., dated January 19th 2005, whereunder PGNiG SA was obliged to pay additional contributions in the amount of PLN 25,999,998, were held before the Regional Court of Warsaw and the Warsaw Court of Appeals. By virtue of its ruling of October 18th 2010, the Regional Court of Warsaw rescinded the resolution on additional contributions. On November 12th 2010, PI GAZOTECH Sp. z o.o. filed an appeal with the Regional Court, along with a petition to be exempt from court fees. The Regional Court of Warsaw accepted the appeal for consideration. On June 28th 2011, PGNiG SA filed a response to the above appeal with the Warsaw Court of Appeals.

Proceedings based upon PGNiG SA's action against PI GAZOTECH Sp. z o.o. to rescind or declare invalidity of the resolution of the General Meeting of PI GAZOTECH Sp. z o.o., dated October 6th 2005, whereunder PGNiG SA was obliged to pay additional contributions in the amount of PLN 6,552,000, were brought before the Regional Court of Warsaw. On May 30th 2008, the Regional Court dismissed the Company's claim and reversed the decision concerning implementation of measures to safeguard the claim (the temporary injunction order). The proceedings to rescind or declare invalidity of the resolution on additional contributions and to maintain the safeguarding measures have been held before the Court of Appeals and the Regional Court of Warsaw since 2008. By virtue of its decision of May 25th 2010, the Court of Appeals changed the Regional Court's decision concerning maintenance of the safeguarding measures dated May 30th 2008 and dismissed the request for reversing the final decision on implementation of the safeguarding measures. During its session held on April 11th 2011, the Regional Court issued a decision suspending the proceedings to rescind or declare invalidity of the resolution on additional contributions.

Proceedings before the President of the Polish 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 abuse of dominant position by PGNiG SA on the domestic natural gas wholesale market, which consisted in inhibiting sale of gas against the interest of other business players or consumers and impeding the development of market conditions necessary for the emergence or growth of competition by refusing to sell gas fuel under a comprehensive agreement to an entrepreneur that intended to further resell the gas, i.e. NowyGaz Sp. z o.o. of Warsaw. The President of UOKiK extended the deadline for closing the anti-trust proceedings to February 29th 2012.

On July 4th 2011, the President of UOKiK instigated anti-trust proceedings concerning abuse of dominant position by PGNiG SA on the domestic natural gas retail market. In the President's opinion, the abuse consisted in impeding the emergence or growth of competition on the domestic natural gas wholesale and retail markets by limiting the possibility to terminate comprehensive agreements for supplies of gas fuel. On August 1st 2011, PGNiG SA sent a letter to the President of UOKiK in which it challenged, in its entirety, the charge of abuse of dominant position by the Company on the domestic natural gas market and applied for the proceedings to be discontinued.

On February 9th 2012, the President of UOKiK instigated anti-trust proceedings concerning practices employed by PGNiG SA which infringe collective consumer interests. The President of UOKiK has accused PGNiG SA of including in the comprehensive agreement for supplies of gas fuel a provision classified as illegal contractual clause.

In each of the cases referred to above, the President of UOKiK may impose on PGNiG SA a fine of up to 10% of the revenue generated by the Company in the financial year preceding the date of the decision imposing the fine.

Proceedings before the Court of Arbitration

On March 31st 2011, PGNiG SA requested OOO Gazprom Export to renegotiate the price of gas deliveries under the Contract dated September 25th 1996, providing for supplies of natural gas to the Republic of Poland, so as to reduce the price. Since the parties failed to reach an agreement in the period of six months, on November 7th 2011, PGNiG SA filed a request to OAO Gazprom and OOO Gazprom Export to start arbitration proceedings before the Court of Arbitration in Stockholm. In accordance with the Court's procedure, on February 20th 2012, the Company filed a suit against OAO Gazprom and OOO Gazprom Export.

Chapter XI: Financial performance

1. Financial performance in 2011

The financial statements of PGNiG SA and the consolidated financial statements of the PGNiG Group for 2011 were audited by Deloitte Audyt Sp. z o.o. The agreement with the audit firm was executed on June 28th 2010 for a period of three years (2010–2012). The agreement provides for:

- audit of the financial statements for 2010, 2011 and 2012 (PGNiG SA and subsidiaries);
- review of the financial statements for Q1 2011, Q1 2012 and Q1 2013 (PGNiG SA);
- review of the financial statements for H1 2010, H1 2011 and H1 2012 (PGNiG SA);
- review of the financial statements for the first three quarters of 2010, 2011 and 2012 (PGNiG SA);
- carrying out certain procedures required by the banks providing financing to PGNiG SA for 2010, 2011 and 2012;
- translation of the audited annual and semi-annual financial statements into English.

The table below presents the fees paid or payable by PGNiG SA to the auditor for 2010–2011.

Auditor's fees (PLN)

	2011	2010
Audit of the annual financial statements	230,000	230,000
Other certification services, including review of financial statements	448,942	320,000
Tax advisory services	-	-
Other services	30,669	11,923
Total	709,611	561,923

1.1. Key financial and business data

In 2011, the PGNiG Group posted a net profit of PLN 1,615.7m, down by PLN 86.4m year on year.

Summary information reflecting PGNiG SA's financial standing in 2011 relative to 2010 is presented below in the financial statements prepared in accordance with the International Financial Reporting Standards, which comprise:

- statement of financial position,
- income statement,
- statement of cash flows,
- selected financial ratios.

Separate statement of financial position (PLNm)

ASSETS	Dec 31 2011	Dec 31 2010
Non-current assets	22,160.6	20,038.8
Property, plant and equipment	12,281.1	10,940.9
Investment property	2.8	3.4
Intangible assets	91.7	81.9
Financial assets available for sale	6,460.3	6,408.7
Other financial assets	2,900.9	2,260.8
Deferred tax assets	347.5	291.5
Other non-current assets	76.3	51.6
Current assets	6,326.1	4,838.3
Inventories	1,897.4	879.3
Trade and other receivables	3,170.3	3,295.1
Current income tax receivable	5.3	-
Prepayments and accrued income	33.3	18.8
Financial assets available for sale	-	-
Derivative financial instrument assets	284.5	77.6
Cash and cash equivalents	934.6	565.9
Non-current assets held for sale	0.7	1.6
Total assets	28,486.7	24,877.1

Separate statement of financial position (PLNm) – contd.

EQUITY AND LIABILITIES	Dec 31 2011	Dec 31 2010
Equity	19,647.6	18,663.7
Share capital	5,900.0	5,900.0
Currency translation differences on foreign operations	9.0	(0.8)
Share premium account	1,740.1	1,740.1
Other capital reserves	10,310.4	9,245.7
Retained earnings/(deficit)	1,688.1	1,778.7
Non-current liabilities	2,019.4	1,758.4
Loans, borrowings and debt securities	-	0.3
Provisions	1,250.6	1,175.5
Deferred income	256.5	76.2
Deferred tax liability	495.7	491.5
Other non-current liabilities	16.6	14.9
Current liabilities	6,819.7	4,455.0
Trade and other payables	2,674.9	2,836.4
Loans, borrowings and debt securities	3,590.8	1,218.7
Derivative financial instrument liabilities	416.8	104.4
Current tax liability	-	135.7
Provisions	135.1	156.3
Deferred income	2.1	3.5
Total liabilities	8,839.1	6,213.4
Total equity and liabilities	28,486.7	24,877.1

Separate income statement (PLNm)

	2011	2010
Sales revenue	21,820.5	20,415.5
Total operating expenses	(20,770.6)	(18,792.7)
Raw and other materials used	(13,523.0)	(11,148.5)
Employee benefits	(895.2)	(857.7)
Depreciation and amortisation	(568.0)	(589.1)
Third-party services	(5,763.9)	(5,799.9)
Cost of products and services for own needs	33.4	20.7
Other operating expenses, net	(53.9)	(418.2)
Operating profit/loss	1,049.9	1,622.8
Finance income	1,026.6	538.7
Finance expenses	(260.8)	(134.9)
Pre-tax profit/loss	1,815.7	2,026.6
Corporate income tax	(200.0)	(324.5)
Net profit/loss	1,615.7	1,702.1

Separate statement of cash flows (PLNm)

	2011	2010
Net cash provided by/used in operating activities	730.3	2,386.0
Net cash provided by/used in investing activities	(1,940.0)	(1,336.1)
Net cash provided by/used in financing activities	1,578.5	(909.3)
Net change in cash	368.8	140.6
Cash and cash equivalents at beginning of period	565.8	425.2
Cash and cash equivalents at end of period	934.6	565.8

Financial ratios

Profitability

	2011	2010
EBIT (PLNm) operating profit	1,049.9	1,622.8
EBITDA (PLNm) operating profit + depreciation/amortisation	1,617.9	2,211.9
ROE net profit to equity at end of period	8.2%	9.1%
NET MARGIN net profit to sales revenue	7.4%	8.3%
ROA net profit to assets at end of period	5.7%	6.8%

Liquidity

	2011	2010
CURRENT RATIO current assets (net of prepayments and accrued income) to current liabilities	0.9	1.1
QUICK RATIO current assets (net of prepayments and accrued income) less inventories to current liabilities	0.6	0.9

Debt

	2011	2010
DEBT RATIO total liabilities to total equity and liabilities	31.0%	25.0%
DEBT/EQUITY RATIO total liabilities to equity	45.0%	33.3%

1.2. Financial overview

Relative to the corresponding period of 2010, the Company's operating profit decreased significantly, by PLN 572.9m. This decline was caused by the considerably lower profitability of high-methane gas sales.

Exploration and Production

The upstream business continued to secure the stability of the Company's financial position. The Exploration and Production segment posted operating profit of PLN 1,280.3m, up by PLN 455.7m on 2010. This increase followed chiefly from higher profitability of crude oil sales, as its selling prices rose by 40%, following the general trend on global markets. Furthermore, the Company recorded a 4% rise in production of nitrogen-rich gas and a 7% increase in output of the denitriding plants.

Trade and Storage

Operating profit of the Trade and Storage segment fell by PLN 1,028.4m relative to 2010. The weakening of the segment's financial position came as a result of the significantly lower profitability of high-methane gas sales, caused mainly by a 24% rise in the unit purchase price of imported gas, driven by higher crude oil prices on the global markets. The increase would have been higher, had it not been for rebates and discounts received in December 2011 under the existing import contracts.

The US dollar, the main currency used in gas imports, depreciated relative to 2010. However, the depreciation was not enough to offset the increase in prices of imported gas pushed up by higher crude oil prices.

The margins on high-methane gas sales deteriorated despite a 5.7% year on year increase in the average gas selling prices and charge rates. The benefits offered by the new tariff effective as of July 2011 were completely eliminated by the strong depreciation of the Polish złoty, pushing profitability of high-methane gas below the break-even point.

The decline of the segment's operating profit was substantially limited due to lower net other operating expenses, attributable primarily to higher reversals of impairment losses on trade receivables, higher income from penalties and compensations, as well as a refund by SGT EUROPOL GAZ S.A. of overpayment for purchased transmission services.

Financial data of PGNiG SA's segments for 2011 (PLNm)

2011	Exploration and Production	Trade and Storage	Other Activities	Eliminations	Total
Sales to external customers	1,853.9	19,963.7	2.9		21,820.5
Intercompany sales	1,175.3	-	-	(1,175.3)	-
Segment revenue	3,029.2	19,963.7	2.9	(1,175.3)	21,820.5
Segment's expenses	(1,748.9)	(20,191.3)	(5.7)	1,175.3	(20,770.6)
Operating profit/loss	1,280.3	(227.6)	(2.8)	-	1,049.9
Net finance expenses					765.8
Share in net profit/loss of entities accounted for using the equity method					-
Pre-tax profit/loss					1,815.7
Corporate income tax					(200.0)
Net profit/loss					1,615.7

Financial data of PGNiG SA's segments for 2010 (PLNm)

2010	Exploration and Production	Trade and Storage	Other Activities	Eliminations	Total
Sales to external customers	1,479.8	18,932.8	2.9	-	20,415.5
Intercompany sales	1,113.2	-	-	(1,113.2)	-
Segment revenue	2,593.0	18,932.8	2.9	(1,113.2)	20,415.5
Segment's expenses	(1,768.4)	(18,132.0)	(5.5)	1,113.2	(18,792.7)
Operating profit/loss	824.6	800.8	(2.6)	-	1,622.8
Net finance expenses					403.8
Share in net profit/loss of entities accounted for using the equity method					0.0
Pre-tax profit/loss					2,026.6
Corporate income tax					(324.5)
Net profit/loss					1,702.1

The Company's net profit was to a large extent attributable to a PLN 362.0m improvement of the result on financing activity. The increase was primarily driven by significantly higher dividend received from the Gas Companies and the sale of shares in Zakłady Azotowe w Tarnowie-Mościcach S.A.

Deterioration of PGNiG SA's financial position is reflected in the decline of the key efficiency ratios. Return on equity decreased from 9.1% to 8.2%; return on assets was 5.7% against 6.8% in 2010, and net margin fell from 8.3% to 7.4%.

As at December 31st 2011, total assets were PLN 28,486.7m, up by PLN 3,609.6m relative to the end of 2010.

Property, plant and equipment, of PLN 12,281.1m as at the end of 2011 (up by PLN 1,340.2m, or 12%, on December 31st 2010), was the largest item of the Company's assets. The increase in the value of property, plant and equipment was primarily attributable to the investment projects implemented by PGNiG SA, as well as to revaluation of assets.

Another material item of the statement of financial position are financial assets available for sale, which stood at PLN 6,460.3m as at December 31st 2011, up by PLN 51.6m on the end of 2010. The increase was driven by equity investments consisting in capital increases at PGNiG SA's direct subsidiaries (mainly PGNiG Norway AS, PGNiG Technologie Sp. z o.o., Pomorska Spółka Gazownictwa Sp. z o.o. and PGNiG Energia S.A.). The item was also affected by the disposal of shares in Zakłady Azotowe w Tarnowie-Mościcach S.A.

Other financial assets stood at PLN 2,900.9m and were by PLN 640.1m higher than as at December 31st 2010. The increase was attributable to higher loans advanced to related entities, including mainly PGNiG Norway AS, and revaluation of the loans to reflect foreign exchange differences.

As at December 31st 2011, current assets of PGNiG SA were PLN 6,326.1m, up by PLN 1,487.8m (or 31%) year on year.

Relative to December 31st 2010, the Company recorded a significant increase in inventories (by PLN 1,018.1m or 116%). The inventories disclosed in the statement of financial position comprise mainly the gas stored in underground storage facilities. The rise in the value of inventories was primarily caused by the increase of the unit purchase price of imported gas and by the higher volume of gas stocks.

Trade and other receivables fell by PLN 124.8m (4%) year on year. The decrease was driven by improved collection of receivables under sale of gas fuels and the increase in receivables under loans advanced to related entities.

Cash and cash equivalents stood at PLN 934.6m, up by PLN 386.7m (65%) on 2010, and followed primarily from an increase in debt under issue of debt securities.

The value and structure of current assets held by PGNiG SA guarantee its ability to settle all liabilities in a timely manner. The current ratio was 0.9, compared with 1.1 as at the end of December 2010; the quick ratio fell from 0.9 to 0.6.

Equity is the primary source of financing of PGNiG SA's assets. Relative to the end of 2010, PGNiG SA's equity rose by PLN 983.9m (or 5%). The level of equity was affected mainly by net profit for the year (PLN 1,615.7m) and payment of non-cash and cash dividend (PLN 708.0m) as part of distribution of previous year's profit.

As at December 31st 2011, non-current liabilities were PLN 2,019.4m, up by PLN 261.0m (15%) on the end of December 2010. The reason was an increase in deferred income due to an investment subsidy granted for construction and extension of the underground gas storage facilities, as well as higher provision for well decommissioning costs and higher contribution to the Mining Facilities Decommissioning Fund.

Current liabilities rose by PLN 2,364.7m (53%) relative to the end of December 2010 chiefly as a result of the increase in loans, borrowings and debt securities. Relative to 2010, the Company significantly increased the external financing to meet its liquidity needs driven mainly by the implementation of investment programmes. Following the execution of the notes issue programmes, as at the end of December 2011 current loans, borrowings and debt securities stood at PLN 3,590.8m, up by PLN 2,372.1m relative to December 2010.

Trade and other payables were down by PLN 161.5m (6%) on December 31st 2010, mainly due to the decrease in purchases of network services, lower liabilities under purchases of non-financial non-current assets, and increase of liabilities under gas imports.

Due to the rise in external financing used by PGNiG SA, the ratios of equity to liabilities changed. Debt to equity increased from 33.1% to 45.0% as at the end of 2011. Debt ratio (total liabilities to total equity and liabilities) went up from 25.0% to 31.0%.

Feasibility of investment projects

Thanks to the positive assessment of PGNiG SA's creditworthiness by rating agencies, as well as the improving situation on the financial markets, the Group has been able to carry out its investment projects as planned. However, as the approval of the new tariff reflecting the increase in price of imported gas is still pending, there is a risk that execution new investment projects may be suspended or limited.

Transactions concluded on non-arm's' length terms

In 2011, PGNiG SA and its subsidiaries did not enter into any material related-party transactions on non-arm's' length terms.

Explanation of differences between the actual results and the forecasts for 2011

In 2011, the Company did not publish any financial forecasts.

2. Financial management

In 2011, PGNiG SA significantly raised the amount of external financing.

In 2011, two annexes were signed to the notes issue programme agreement signed with six banks on June 10th 2010. Under the annexes, three new banks, i.e. BRE Bank S.A., Bank Zachodni WBK S.A. and Nordea Bank Polska S.A., joined the agreement. The value of the notes issue programme was increased to PLN 7bn, and the agreement term was extended until July 31st 2015. Under the programme, PGNiG may issue discount and coupon notes with maturities ranging from one month to one year. In 2011, the Company issued notes with a total nominal value of PLN 16.4bn. As at December 31st 2011, the debt under the programme stood at PLN 3.3bn. PGNiG SA used the proceeds from the issue to finance main investment projects involving field development, construction and extension of underground storage facilities, as well as PGNiG SA's operations. In addition, In January 2012, PGNiG SA, through its subsidiary SPV 1 Sp. z o.o., acquired shares in Vattenfall Heat Poland S.A.

On August 25th 2011, PGNiG SA signed the documentation for a five-year Eurobond issue programme of up to EUR 1.2bn with PGNiG Finance AB and three banks (Societe Generale SA, BNP Paribas SA and UniCredit Bank AG). Under the programme, PGNiG Finance AB of Stockholm, PGNiG SA's wholly-owned subsidiary, will issue on the European market fixed or floating rate medium-term bonds with maturities of up to 10 years . On August 25th 2011, PGNiG SA granted a guarantee of up to EUR 1.5bn in respect of repayment by PGNiG Finance AB of the liabilities under the Eurobond programme. The guarantee remains valid until December 31st 2026. The first EUR 500m tranche of Eurobonds with a five-year maturity and a yield of 4.098% p.a. was issued on February 10th 2012. The bonds were assigned the Baa1 (Moody's) and BBB+ (Standard & Poor's) credit ratings. Proceeds from the issue will be used to finance PGNiG S.A's investment programme and its day-to-day operations.

Furthermore, pursuant to the agreement of December 1st 2010, the Company continues to issue short-term discount notes to the companies of the PGNiG Group. The agreement is valid until November 30th 2013. By virtue of an annex of June 10th 2011, the value of the programme was increased from PLN 397.3m to PLN 1bn. In 2011, the Company issued notes with a nominal value of PLN 4.6bn. The note issue programme provides for a flow of cash from the companies having excess to liquidity and optimises liquidity management within the Group. As at December 31st 2011, PGNiG SA's debt under the notes in issue amounted to PLN 297.5m.

The funds available to PGNiG SA ensure timely financing of all current and planned expenditure related to the core business and investing activities. External financing is raised mainly through debt securities issue programmes. Moreover, PGNiG SA has a liquidity reserve in the form of overdraft facility agreements (PLN 280m total). In 2011, the Company used overdraft facilities to a limited extent. In the long term, the negative margin on sales of imported natural gas may lead to a downgrade of the credit rating and considerably increase borrowing costs.

2.1. Short-term investments

The financial investments made by PGNiG SA in 2011 were short-term, with maturities of up to one month. The Company invested in instruments carrying the lowest possible credit risk, mainly bank deposits, which represented 95% of the investments. Conditional purchases/sales of treasury securities accounted for the remaining 5% of transactions. Such placements were consistent with PGNiG SA's financial investment policy adopted by the Company's governing bodies and with the Issue Prospectus.

2.2. Loan agreements

In 2011, PGNiG SA entered into overdraft facility agreements for a total amount of PLN 280m. The table below presents the details of loan agreements executed by the Company in 2011.

PGNiG SA's loan agreements

Bank	Loan amount (PLNm)	Interest rate	Type	Maturity date
Bank Handlowy w Warszawie S.A.	40.0	1M WIBOR + 0.30%	working capital loan	Dec 31 2012
Bank Pekao S.A.	40.0	1M WIBOR + 0.45%	working capital loan	Jul 31 2012
PKO BP S.A.	40.0	1M WIBOR + 0.60%	working capital loan	Jul 13 2012
BRE Bank S.A. [1]	40.0	O/N WIBOR + 0.15%	working capital loan	Sep 7 2012
Societe Generale S.A. Polish Branch	40.0	1M WIBOR + 0.40%	working capital loan	Aug 31 2012
ING Bank Śląski S.A.[2]	40.0	1M WIBOR + 0.40%	working capital loan	Dec 6 2012
Bank Millenium S.A.	40.0	1M WIBOR + 0.40%	working capital loan	Dec 18 2012

[1] during the term of the agreement, the interest rate was changed from ON WIBOR + 0.19% to ON WIBOR + 0.15%.
[2] during the term of the agreement, the interest rate was changed from ON WIBOR + 0.50% to ON WIBOR + 0.40%.

In 2011, PGNiG SA did not terminate any loan agreements.

In 2011, PGNiG SA executed loan agreements only with related entities, for an aggregate amount of PLN 3,935.9m and NOK 650m. Loans denominated in PLN were granted chiefly to finance equity investments. A loan in the amount of PLN 3,780m, advanced to PGNiG SPV 1 Sp. z o.o. to finance the acquisition of Vattenfall Heat Poland shares, was the largest of the loans. PGNiG SA also advanced several other loans, which were mostly investment loans for construction and extension of gas network, construction of new connections and purchase of drilling equipment. The NOK denominated loan (under an annex to the loan agreement of 2010) was granted to finance capital expenditure related to the project executed on the Norwegian Continental Shelf. The table below presents detailed information on the loans advanced by PGNiG SA.

Loans advanced by PGNiG SA

Company	Loan amount (PLNm)	Currency	Interest rate	Type	Maturity date
PGNiG Norway AS	650.0	NOK	3M NIBOR + 2.25%	investment	Dec 20 2021
PGNiG SPV 1 Sp. z o.o.	3,780.0	PLN	3M WIBOR+1.5%	investment	Dec 31 2012
PNiG Jasło Sp. z o.o.	60.0	PLN	3M WIBOR + 2.0%	investment	Mar 31 2017
Mazowiecka Spółka Gazownictwa Sp. z o.o.	53.0	PLN	1M WIBOR +3.5%	investment	Aug 31 2023
PGNiG Energia S.A.	15.0	PLN	1M WIBOR + 1.0%	investment/working capital loan	Jul 1 2012
PGNiG Technologie Sp. z o.o.	20.0	PLN	1M WIBOR + 2.0%	working capital loan	May 82015
PGNiG Technologie Sp. z o.o.	5.8	PLN	1M WIBOR + 2.0%	investment	Dec 31 2011
PGNiG Technologie Sp. z o.o.	2.1	PLN	1M WIBOR + 2.0%	working capital loan	Dec 31 2011

In 2011, PGNiG SA did not contract or terminate any loans from entities other than banks.

2.3. Guarantees and sureties

In 2011, PGNiG SA provided guarantees and sureties for a total amount of PLN 7,390.1m. The most significant of them were:

- EUR 1,500m (PLN 6,625.2) guarantee for the liabilities of PGNiG Finance AB under the Eurobond programme, which remains valid until December 31st 2026
- NOK 600m (PLN 340.6m) guarantee for PGNiG Norway AS's liabilities towards GASSCO; the guarantee remains valid until April 1st 2024 and covers PGNiG Norway AS's liabilities under tariff charges for transmission of gas in the Norwegian gas transport system Gassled.

In 2011, PGNiG SA received guarantees and sureties for a total amount of PLN 48.3m, of which 34% (PLN 16.4m) was attributable to guarantees and sureties of less than PLN 500 thousand. The remaining guarantees and sureties were performance bonds, including bonds securing gas contracts. The most significant of the guarantees and sureties was the PLN 7.8m performance bond issued by a consortium comprising Control Process Sp. z o.o., STALBUD Tarnów Sp. z o.o. and Biuro Projektów „NAFTA GAZ" Sp. z o.o., related to the construction of the surface part of the Kosakowo Underground Gas Storage Facility.

2.4. Financial risk management

The main objective of PGNiG S.A's financial risk management policy is to limit the volatility of cash flows related to the Company's operations to levels which are acceptable in the short- and mid-term perspective and to build the company value in the long term. In its business activities in 2011, PGNiG SA was exposed to a number of financial risks, and in particular to market risk (including commodity price, interest rate and currency risks) as well as liquidity and credit risks.

Market risk

PGNiG SA manages market risk through identification, measurement, monitoring and mitigation of key sources of risk, i.e. the adverse effect of changes in commodity prices, exchange rates and interest rates on the Company's financial performance.

The key risks to which the Company is exposed include the risk of commodity price and exchange rate fluctuations, which affect the Company's gas purchases.

In 2011, PGNiG SA used the following financial instruments to manage the gas price risk:
- purchases of Asian commodity call options settled as European options;
- commodity option structures (consisting in a combination of two commodity options);
- commodity swaps based on the average price of gas over the term of the transaction.

In 2011, to mitigate the currency risk the Company used the following financial instruments:
- Forward contracts
- FX swaps
- purchases of currency call options;
- option structures (in most cases consisting in a combination of two currency options).

PGNiG SA also used CCIRS transactions (to mitigate the FX and interest rate risks) to hedge the loan advanced to PGNiG Norway AS.

The Company has used cash flow hedge accounting with respect to transactions hedging payments for gas and with respect to transactions hedging gas prices. The application of cash flow hedge accounting allows the Company to charge the effective portion of the hedge to revaluation capital reserve, which results in the matching of the effect on profit or loss of valuation of hedging instruments and the result on the hedged item. This approach allows to eliminate profit or loss volatility attributable to valuation of derivative instruments and makes it possible to offset its effect in the income statement in the same reporting period. In consequence, the economic and accounting effects of the hedge are reflected in the same period.

Credit risk

PGNiG SA's credit risk is related to the likelihood of failure by the counterparties or other entities to meet their obligations to the Company. In 2011, the Company managed credit risk by investing its free cash in instruments carrying the lowest possible credit risk (treasury bonds and bills), entering into framework agreements with its counterparties (precisely defining the rights and obligations of the parties), and diversifying its counterparties. PGNiG SA also worked with leading commercial banks. The key criteria for the selection of counterparties to whom the Company entrusted a portion of its assets included their financial standing as confirmed by rating agencies, and their respective market shares.

Risk of cash-flow disruptions

The measures taken by PGNiG SA to mitigate the risk of disruptions in its day-to-day operating cash flows included diversification of electronic banking systems used, ongoing monitoring of credit/debit transactions in bank accounts, collecting information on cash flows within the Company and the Group, consolidating bank accounts and entering into overdraft facility agreements. The Company mitigated any cash flow volatility on payments under the gas contracts by entering into FX risk hedges (currency options, option strategies) and gas price hedges (Asian options, option strategies and commodity swaps).

Liquidity risk

In order to mitigate its liquidity risk, in 2011 PGNiG SA signed annexes to the overdraft facility agreements executed in 2010 and the PLN 7bn notes issue programme agreement. PGNiG SA also prepared cash flow projections for the Company and the Group, assessed the condition and value of assets available for sale, maintained highly liquid financial assets and cooperated with rating agencies.

3. Projected future financial performance

Key factors with a bearing on PGNiG SA's financial performance will include crude oil prices on international markets, conditions prevailing on the currency markets, and the position of the Energy Regulatory Office on gas fuel tariffs.

The financial position of PGNiG SA is to a significant extent affected by the prices of crude oil and petroleum products. Following the adverse developments in the global political and economic environment in 2011, crude oil prices on the international markets increased. If the current trend continues, crude prices may continue to rise in the coming quarters.

PGNiG SA is significantly exposed to changes in foreign exchange rates and, consequently, to fluctuations in PLN-denominated prices of imported gas. In Q3 and Q4 2011 the Polish currency weakened significantly. Further weakening of the złoty may have a material adverse effect on the Company's financial performance.

Another factor with a bearing on the Company's financial results is the level of prices and charges set in the gas fuel tariffs. The tariff currently applied by PGNiG SA had been originally scheduled for the period until December 31st 2011. Given the unfavourable developments on the currency and fuel markets, in October 2011, PGNiG SA filed two applications with the Energy Regulatory Office: the first requesting the approval of an adjustment to the then effective tariff and the other requesting a new tariff for Q1 2012. As at the date of this report, proceedings were pending. In the current market climate, if the new tariff is not approved, PGNiG SA will suffer losses on operations and suspend new projects, and may lose financial liquidity.

In 2011, PGNiG SA started to renegotiate the price of gas supplied under the long-term contract with OOO Gazprom Export and then referred the case to the Arbitration Court in Stockholm. If the dispute is settled in favour of PGNiG SA, it will help reduce the cost of gas imports.

In 2011, PGNiG SA and OGP GAZ-SYSTEM S.A. executed an agreement for additional gas supplies to Poland with the use of virtual reverse flow on the Yamal Pipeline. The agreement permits the Company to purchase gas at lower prices than those specified in the contract with OOO Gazprom Export. The first volumes of gas were supplied in November and December 2011 through PGNiG Sales & Trading GmbH. In 2012, the Company plans to continue supplies with the use of reverse flow which will help improve the balance of gas supplies to Poland.

External financing of the Company's operations in 2012 will be based on the PLN 3.0bn notes issue programme under the agreement concluded with six banks on June 10th 2010 (under the annexes, the value of the programme was increased to PLN 7bn). The agreement will remain in force until July 31st 2015. Also, on August 25th 2011, PGNiG SA and three banks signed the documentation for a EUR 1.2bn medium-term Eurobond issue programme. The first EUR 500m tranche of Eurobonds was issued by PGNiG Finance AB on February 10th 2012.

In the coming quarters, PGNiG SA intends to maintain the high level of capital expenditure, mainly on projects designed to extend the underground gas storage facilities, maintain hydrocarbon production capacities, and diversify gas supply sources, as well as on projects related to the exploration for and appraisal of crude oil and natural gas deposits and development of the power generation segment.

In January 2012, PGNiG SA completed the transaction of purchase of 99.8% of shares in Vattenfall Heat Poland SA (now PGNiG TERMIKA S.A.). PGNiG TERMIKA S.A. is to be the main competence centre for large gas-fired power projects.

Members of the Management Board

Vice-President of the Management Board	Radosław Dudziński	
Vice-President of the Management Board	Sławomir Hinc	
Vice-President of the Management Board	Marek Karabuła	
Vice-President of the Management Board	Mirosław Szkałuba	