

**Ladies and Gentlemen,**

In the year 2006, the Management of Polish Oil and Gas Company moved on a number of strategic projects to the implementation phase. These efforts were aimed at ensuring safe and secure gas supply for the customers of the PGNiG Group and continued growth and modernisation of the company. The main focus was on the development of the exploration and production activity, increase of the underground gas storage capacity and the projects supporting diversification of the gas supply sources and directions. We were also preparing for the alignment of organisational structure of the PGNiG Group with the requirements of the EU directive, which implies unbundling of the trading function and the technical distribution of gas as of 1 July 2007. In building a recognisable and reliable brand of the PGNiG Group we concentrated on the preparing the company for operation in a liberalised, European gas market. Our goal is to strengthen the position of the PGNiG Group in this market as a leading gas company in the Central and Eastern Europe that is fully capable of facing the challenges of competition.

**Financial condition**

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

We are perceived by the financial markets as a stable company that strives for performance improvement at very level of the income statement. In recognition of this fact, Standard&Poor's upgraded the rating of PGNiG to "BBB+". In the rationale for its decision, the agency underlined the positive outlook for further value growth of the company and increased financial liquidity of PGNiG. Specifically, the agency noted the good profit growth prospects for PGNiG related to its exploration and production business, including the increased share of the domestic production in the satisfaction of the growing demand for natural gas in Poland.

**Diversification of supply sources and directions**

In line with our commitment to fulfil the obligations towards the shareholders of the Company and to ensure transparency, we emphasise the long-term nature of the projects aimed at ensuring secure, undisturbed gas supply and the substantial capital needs involved. In addition to long-term supply contract, in 2006 we were working towards diversification of the supplier base and the directions the gas volumes distributed by the Group originate from. By diversifying its supplier portfolio, the PGNiG Group builds a good position for successful international expansion and has demonstrated the strategic significance of this goal with the decision on the construction of a receiving terminal for liquefied natural gas and the acquisition of fields in the Norwegian Continental Shelf.

The key project in this area initiated in 2006 concerned the preparation of the feasibility study and the technical and economic assumptions for the LNG imports to Poland. On 15 December 2006, on the

basis of technical and economic criteria, the Management Board decided on the location of the LNG regasification terminal in Swinoujscie. Currently, the Company is preparing to start the construction phase of the terminal, which initially, in 2011, will have handling capacity of 2.5 billion cu. m of gas per annum. With this innovative project, Poland will enter the worldwide LNG market, diversify its gas supply and by achieving greater flexibility, reduce its dependency on gas imports from a single direction.

Another project that will have a positive impact on the diversification of the structure of gas supply to Poland concerns the efforts aimed at establishing a connection with hydrocarbon fields in the North Sea. In 2006, we resumed the talks with the Scandinavian counterparts to develop the necessary infrastructure. At the same time, in the second half of the previous year, the Management Board of PGNiG started negotiations aimed at the acquisition of 15% interests in exploration and production licences in Skarv and Snadd fields in the Norwegian Continental Shelf from Mobil Development Norway A/S and ExxonMobil Production Norway Inc. The relevant conditional agreement was signed on 28 February 2007. The first oil and gas production from these fields is expected in mid 2011. The acquisition of interests in licence blocks in the Norwegian Sea opens up new business opportunities for the PGNiG Group and will enable active participation in the international gas market. This also means the possibility of gaining new, valuable experience in offshore exploration and production well drilling, also in cooperation with such international companies as Shell, Statoil, Norsk Hydro or BP.

#### **Development of trading activity**

In 2006, the PGNiG Group sold 13.7 bcm of gas and 515 thousand tons of crude oil. Operating in a very dynamic international environment, we fully secured the domestic consumption needs with new long-term contracts, i.e. one concluded between PGNiG and VNG AG on 17 August 2006 and valid until 2016 (for annual gas supply volume ranging from 400 to 500 million m<sup>3</sup>) and the contract of 17 November 2006 concluded with RosUkrEnergo AG until 2009 (for purchase of 2.5 billion m<sup>3</sup> of gas per annum) with an extension option for further 2 years.

In accordance with the prescriptions of Directive 2003/55/EC of the European Parliament and the Council and the amended Energy Law, the Company started the preparations for legal unbundling of the trading activities from technical distribution of gas by 1 July 2007. As a part of this process, Distribution System Operators will be spun off from the existing Gas Distribution Companies. All wholesale and retail activities will be integrated in a newly established Trading Branch of PGNiG. The integration of the trading function in PGNiG will lead to creation of a focused gas sales unit and implementation of new service standards aligned to the needs of specific customer segments. We are strengthening the relationships with our customers to make sure that the value proposition of PGNiG remains attractive for them and meets the requirements of a liberalised market after 1 July 2007, for which we are preparing the Company in accordance with the provisions of the directive.

However, full utilisation of the economic potential of the PGNiG Group in its core business depends on the revenues from gas sales, which are determined by the tariffs regulated by the Chairman of the Energy Regulatory Authority. In this area, the key threat for the efficient operation of the company stems from the fact that the real costs of imported gas sourcing and the necessary investments into storage capacity development are not fully reflected in the regulated tariffs. As a result, the Group has currently limited options for treating the domestic gas fields as the strategic reserve, and at the same time is not in the position to implement further investments in the exploration and exploitation of these reserves on fully satisfactory terms.

Therefore, the Management of PGNiG is consistently striving for a tariff policy that takes into account all price-related elements that are justified by both the economic reality and the national energy security considerations.

#### **Expansion of storage capacity**

At the moment the PGNiG Group has seven underground gas storage facilities and is implementing a programme to increase the capacity up to 2.8 bcm by 2012, so that it corresponds to approx. 17% of the domestic gas consumption. The investments into storage infrastructure are a strategic decision of the PGNiG Group, and its purpose is not limited to fulfilling the new requirements of the act on mandatory stocks of crude oil, petroleum products and natural gas, which came in force in 2007. It is also meant to prepare the Company for the competitive game in the European gas market. In 2006, the Company started the development of two new caverns in the Mogilno UGS and was preparing further investment projects, including the expansion of the UGS facilities in Wierzchowice and Strachocina. We expect that the expenditures on storage capacity expansion will total approx. PLN 1.4 bn.

#### **Development of exploration and production activity**

The geophysical and drilling companies of the PGNiG Group have been carrying out highly successful exploration in the Carpathians, the Carpathian Foredeep and the Polish Lowlands. The domestic reserves are estimated at 102.5 bcm of natural gas and 21.4 million tons of crude oil. As a result of these efforts, the volume of proven reserves compared to the yearly production of the PGNiG Group, measured by the R/P ratio, is 26 years, which is a very good result comparing to such European gas companies as Shell, ExxonMobil, BP, Total or Gazprom. Also the Reserves Replacement Ratio achieved by the Group stands at a very good level of 1.4, which means that the company discovers more fields than it produces from the existing ones thereby increasing the level of its reserves. Nearly 30% of the gas sold in 2006 originated from domestic production. Among other things, this was enabled by the commissioning of a new gas production facility in Jasionka near Rzeszow, the development of the Biszczka-Ksiezopol fields and the modernisation of the nitrogen removal plant in Odolanow.

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

**Ladies and Gentlemen,**

In 2006, we launched a number of initiatives and projects that should have long-term impact on our business activity. They have been defined in "The Policy Directions for the PGNiG Group until 2011" adopted by the Management Board and the Supervisory Board. The document provides a set of guidelines for optimum use of the Group's assets and structures further development of the company.

We are undergoing a challenging process of change and transformation, which is aimed at improvement of the Company's operations and strengthened cooperation within the Group in order to explore potential synergies. The year 2007 will be crucial for our future. The capabilities, unique expertise and commitment of nearly 30 thousand employees are a strong asset of the PGNiG Group. In 2006, the main objective was to build a favourable starting position to become a leading gas company in the Central Europe and, subsequently, an active player in the international market. We hope that with our joint effort we will ensure that Group will not only be perceived as a reliable business partner in the Polish market, but also as a company that is increasingly well managed and is capable of facing the challenges of the liberalised European market.

Krzysztof Głogowski  
President of the Management Board