



PGNiG

**Polskie Górnictwo Naftowe
i Gazownictwo SA**

**DIRECTORS' REPORT
ON PGNIG GROUP'S OPERATIONS IN 2008**

Warsaw, April 7th 2009

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Statement on Compliance with Corporate Governance Principles at Polskie Górnictwo Naftowe i Gazownictwo S.A. in 2008.

Chapter I: Information on the PGNiG Group

The PGNiG Group is the only vertically integrated gas company in Poland, holding the leading position in most segments of the domestic gas sector. Polskie Górnictwo Naftowe i Gazownictwo S.A. is the parent undertaking of the PGNiG Group.

Polskie Górnictwo Naftowe i Gazownictwo Spółka Akcyjna (PGNiG S.A.), with registered office in Warsaw, ul. Marcina Kasprzaka 25, was established as a result of transformation of the state-owned enterprise under the name Polskie Górnictwo Naftowe i Gazownictwo 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. On November 14th 2001, the Company was entered into the Register of Entrepreneurs of the National Court Register under entry No. 0000059492.

On May 24th 2005, PGNiG S.A. shares were admitted to public trading by virtue of a decision issued by the Polish Securities and Exchange Commission. The Company's debut on the Warsaw Stock Exchange took place on September 23rd 2005. PGNiG S.A. shares have been listed on the WSE since October 20th 2005. Currently, the Company's share capital amounts to PLN 5.9bn and is divided into 5,900,000,000 shares.

The scope of the PGNiG Group's business comprises exploration of reserves, extraction and storage of gaseous fuels as well as trade in and distribution of natural gas. The natural gas and crude oil production are among the key factors securing the Company's competitive advantage on the liberalised gas market. The core business of the PGNiG Group includes trade in and distribution of natural gas. The trading activities are handled by PGNiG S.A. and the distribution is carried out by six Gas Companies— members of the Group.

1. Development Areas

The key strategic objective pursued by the PGNiG Group is to secure shareholder value growth. The growth in the PGNiG Group's value is to be achieved by the development of the domestic gas market and expansion into selected foreign markets.

The strategic objective provided for in the PGNiG Group's policy is to develop its trading operations and ensure security and continuity of natural gas supplies to Poland by building international interconnections and entering into gas purchase contracts. The development of appropriate diversification infrastructure will allow the Company to supply gas to Poland from different countries and from different suppliers, which will significantly enhance the bargaining power of PGNiG S.A. and will guarantee balanced gas supplies to the PGNiG Group's customers.

High commodity prices in the global markets and growing competition for access to natural gas deposits encourage the PGNiG Group to step up work to enhance the growth potential of its exploration and production business in Poland and abroad by expanding its own natural gas and crude oil reserves and acquiring new licences in the selected foreign markets. The PGNiG Group intends to establish stable positions on three key foreign markets in the North Sea, North Africa and Middle East regions.

Another important area of the PGNiG Group's growth is the extension and construction of underground gas storage facilities. The PGNiG Group strives to ensure sufficient storage capacities in order to enhance its ability to flexibility in reacting to customer demands, to secure the continuity and

stability of gas supplies, and to mitigate risks in situations when supplies from foreign sources are threatened.

The distribution business has an important role in the building of the PGNiG Group's value. One of the PGNiG Group's strategic objectives is to improve profitability in the distribution area by maximising revenue from regulated operations, cost rationalisation and distribution network development.

Implementation of these objectives will ensure gradual transformation of the PGNiG Group from a vertically integrated gas and oil organisation into a strong multi-energy company, which groups businesses from the power, fuel, heat and chemical sectors. The extension and expansion of the operations of the PGNiG Group will strengthen its position on the energy market in Poland and Central Europe.

2. Structure of the PGNiG Group

As at December 31st 2008, the PGNiG Group comprised PGNiG S.A. (the parent undertaking) and 33 production and service companies, including:

- 26 subsidiaries of PGNiG S.A.;
- 7 indirect subsidiaries of PGNiG S.A.

The table below presents a list of the Group members as at December 31st 2008.

		Share capital (PLN)	Shareholding of PGNiG S.A. (PLN)	% of share capital held by PGNiG S.A.	% of the total vote held by PGNiG S.A.
	Subsidiaries of PGNiG S.A.				
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⁾	497,327,000.00	497,327,000.00	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	INVESTGAS S.A.	502,250.00	502,250.00	100.00%	100.00%
11	Dolnoślaska Spółka Gazownictwa Sp. z o.o.	655,063,000.00	655,063,000.00	100.00%	100.00%
12	Górnoślaska Spółka Gazownictwa Sp. z o.o.	1,288,680,000.00	1,288,680,000.00	100.00%	100.00%
13	Karpacka Spółka Gazownictwa Sp. z o.o.	1,484,953,000.00	1,484,953,000.00	100.00%	100.00%
14	Mazowiecka Spółka Gazownictwa Sp. z o.o.	1,251,738,000.00	1,251,738,000.00	100.00%	100.00%
15	Pomorska Spółka Gazownictwa Sp. z o.o.	614,696,000.00	614,696,000.00	100.00%	100.00%
16	Wielkopolska Spółka Gazownictwa Sp. z o.o.	978,287,000.00	978,287,000.00	100.00%	100.00%
17	B.S. i P.G. Gazoprojekt S.A.	4,000,000.00	3,000,000.00	75.00%	75.00%
18	BUG Gazobudowa Sp. z o.o.	39,220,000.00	39,220,000.00	100.00%	100.00%
19	Zakład Urządzeń Naftowych Naftomet Sp. z o.o.	23,500,000.00	23,500,000.00	100.00%	100.00%
20	Geovita Sp. z o.o.	86,139,000.00	86,139,000.00	100.00%	100.00%
21	Budownictwo Naftowe Naftomontaż Sp. z o.o.	44,751,000.00	39,751,000.00	88.83%	88.83%

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22	Górnictwo Naftowe Sp. z o.o.	50,000.00	50,000.00	100.00%	100.00%
23	NYSAGAZ Sp. z o.o.	3,700,000.00	1,887,000.00	51.00%	51.00%
24	ZRUG Sp. z o.o. (Pogórska Wola)	4,300,000.00	4,300,000.00	100.00%	100.00%
25	BUD-GAZ PPUH Sp. z o.o.	51,760.00	51,760.00	100.00%	100.00%
26	PPUih TURGAZ Sp. z o.o.	176,000.00	90,000.00	51.14%	51.14%
		Share capital (PLN)	Shareholding of PGNiG S.A. subsidiaries (PLN)	% of share capital held by PGNiG S.A. subsidiaries	% of the total vote held by PGNiG S.A. subsidiaries
	Subsidiaries of PGNiG S.A. subsidiaries				
27	GEOFIZYKA Kraków Libya JSC (LYD) ^{1), 2)}	1,000,000.00	600,000.00	60.00%	60.00%
28	Geofizyka Torun Kish Ltd (Rial) ^{1), 3)}	10,000,000.00	10,000,000.00	100.00%	100.00%
29	Oil Tech International F.Z.E. (USD) ¹⁾	20,000.00	20,000.00	100.00%	100.00%
30	Zakład Gospodarki Mieszkaniowej Sp. z o.o. (Piła)	1,806,500.00	1,806,500.00	100.00%	100.00%
31	GAZ Sp. z o.o. (Błonie)	300,000.00	153,000.00	51.00%	51.00%
32	GAZ MEDIA Sp. z o.o. (Wołomin)	300,000.00	153,000.00	51.00%	51.00%
33	NAFT-STAL Sp. z o.o.	667,500.00	450,000.00	67.40%	67.40%

¹⁾ Figures shown in foreign currencies.

²⁾ Paid up: LYD 300,000.00, including LYD 180,000.00 paid by GEOFIZYKA Kraków Sp. z o.o.

³⁾ Not paid up.

In 2008, the changes in the company names from Operator Systemu Dystrybucyjnego Sp. z o.o. to Spółka Gazownictwa Sp. z o.o. were registered.

The following changes in the Group's structure occurred in 2008:

- Registration of amendments to the articles of association of PGNiG Finance B.V. (the Netherlands, February 4th 2008); under the amended articles of association, the company's name was changed to Polish Oil and Gas Company - Libya B.V. and its business profile was redefined;
- Deletion of ZRUG Warszawa S.A. (in liquidation) from the Register of Entrepreneurs on March 31st 2008 (its shareholders included PGNiG S.A. with a 49% interest in the company's share capital and Mazowiecka Spółka Gazownictwa Sp. z o.o. with a 49% interest);
- Conclusion of a share purchase agreement providing for the sale of a 100% interest in Polskie LNG Sp. z o.o. between PGNiG S.A. and OGP GAZ-SYSTEM S.A.; PGNiG S.A. sold to OGP GAZ-SYSTEM S.A. 50,000 Polskie LNG Sp. z o.o. shares, with a par value of PLN 1,000 per share, for a total price of PLN 52,000,000; the ownership title to the Polskie LNG Sp. z o.o. shares was transferred to the purchaser on December 8th 2008.

Furthermore, on January 29th 2008, Geofizyka Kraków Sp. z o.o. established a joint-stock company incorporated under Libyan law, under the name of Geofizyka Kraków Libya JSC. The shares in the company are held by two shareholders: Geofizyka Kraków Sp. z o.o. (60% of the share capital) and BARARI Co. For Oil Services (40% of the share capital). The company's share capital amounts to LYD 1,000,000.00 and is divided into 10,000 shares with a par value of LYD 100 per share. Upon incorporation of Geofizyka Kraków Libya JSC, the shareholders paid LYD 300,000.00. The balance will be paid within five years from the date of the company's registration. The company's core business is exploration for hydrocarbon deposits in Libya.

The following changes occurred in the PGNiG Group's capital structure in 2008:

- Share capital increase at Polskie LNG Sp. z o.o. by PLN 11,000,000, to PLN 50,000,000; the increase was registered with the National Court Register on January 7th 2008;
- Share capital increase at Mazowiecka Spółka Gazownictwa Sp. z o.o. by PLN 286,531,000, to PLN 1,217,350,000; the increase was registered with the National Court Register on January 24th 2008; the newly issued shares were acquired by PGNiG S.A. in exchange for a contribution of non-current assets comprising the components of a transmission or distribution network; another share capital increase at the company by PLN 34,388,000, to PLN 1,251,738,000; the increase was registered with the National Court Register on September 9th 2008; the newly issued shares were acquired by PGNiG S.A. in exchange for a contribution of non-current assets comprising the components of a transmission or distribution network with a total book value of PLN 32,868,262,60, and a cash contribution;
- Share capital increase at Karpacka Spółka Gazownictwa Sp. z o.o. by PLN 165,363,000, to PLN 1,476,112,000; the increase was registered with the National Court Register on February 12th 2008; another share capital increase at the company by PLN 8,841,000, to PLN 1,484,953,000; the increase was registered with the National Court Register on August 22nd 2008; the newly issued shares were acquired by PGNiG S.A. in exchange for a contribution of non-current assets comprising the components of a transmission or distribution network;
- Share capital increase at Pomorska Spółka Gazownictwa Sp. z o.o. by PLN 93,391,000, to PLN 596,141,000; the increase was registered with the National Court Register on February 29th 2008; another share capital increase at the company by PLN 18,555,000, to PLN 614,696,000; the increase was registered with the National Court Register on August 4th 2008; the newly issued shares were acquired by PGNiG S.A. in exchange for a contribution of non-current assets comprising the components of a transmission or distribution network;
- Share capital increase at GEOFIZYKA Kraków Sp. z o.o. by PLN 30,000,000, to PLN 64,400,000; the increase was registered with the National Court Register on April 2nd 2008;
- Share capital increase at Dolnośląska Spółka Gazownictwa Sp. z o.o. by PLN 104,697,000, to PLN 651,145,000; the increase was registered with the National Court Register on April 9th 2008; another share capital increase at the company by PLN 3,918,000, to PLN 655,063,000; the increase was registered with the National Court Register on October 30th 2008; the newly issued shares were acquired by PGNiG S.A. in exchange for a contribution of non-current assets comprising the components of a transmission or distribution network;
- Share capital increase at Wielkopolska Spółka Gazownictwa Sp. z o.o. by PLN 131,128,000, to PLN 978,287,000; the increase was registered with the National Court Register on May 27th 2008; the newly issued shares were acquired by PGNiG S.A. in exchange for a contribution of non-current assets comprising the components of a transmission or distribution network;
- Share capital increase at Górnośląska Spółka Gazownictwa Sp. z o.o. by PLN 91,366,000, to PLN 1,288,680,000; the increase was registered with the National Court Register on June 25th 2008; the newly issued shares were acquired by PGNiG S.A. in exchange for a contribution of non-current assets comprising the components of a transmission or distribution network; pursuant to its resolution of August 5th 2008, the Extraordinary General Shareholders Meeting of Górnośląska Spółka Gazownictwa Sp. z o.o. resolved to further increase its share capital by PLN 10,808,000, to PLN 1,299,488,000; the newly issued shares were acquired by PGNiG S.A.; as at the date of this report, the share capital increase has not been registered with the National Court Register.

In 2008, also Wielkopolska Spółka Gazownictwa Sp. z o.o. increased its share capital, by PLN 54,899,000, to PLN 1,033,186,000. The increase was registered with the National Court Register on January 22nd 2009. The newly issued shares were acquired by PGNiG S.A. in exchange for a contribution of non-current assets comprising the components of a transmission or distribution network.

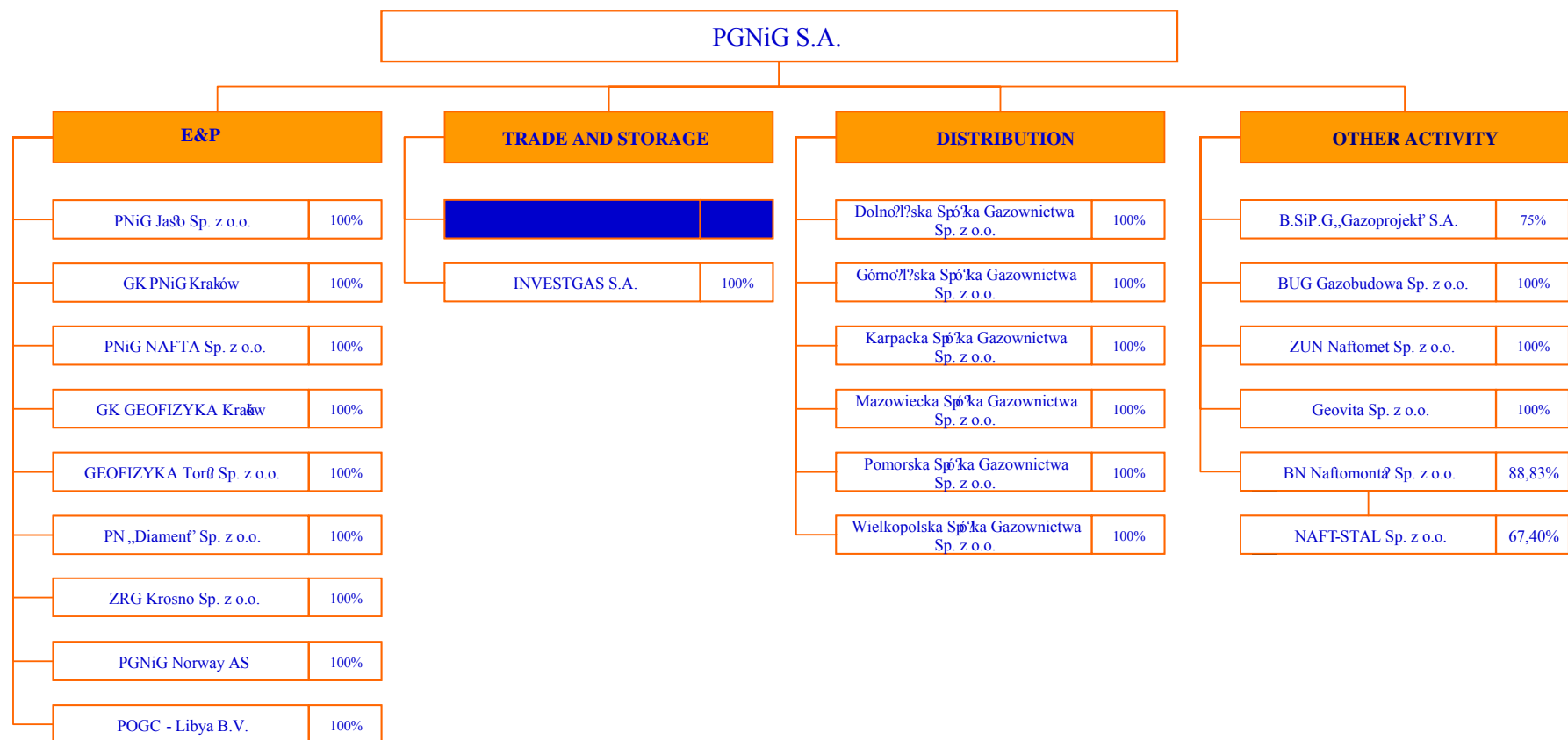
Changes in the PGNiG Group's Structure Subsequent to the End of the Financial Year

Following the end of the financial year, Mazowiecka Spółka Gazownictwa Sp. z o.o. and Biuro Studiów i Projektów Gazownictwa Gazoprojekt S.A. established a special purpose company under the name of POWISLE PARK Sp. z o.o., registered office in Warsaw, whose objective is to build the head office of MSG Sp. z o.o. as well as flats, offices and commercial space for sale. The company was established for the period necessary to complete the project. The share capital of the new company amounts to PLN 78,131,000. MSG Sp. z o.o. acquired 76,131 shares, with a par value of PLN 1,000 per share and the aggregate value of PLN 76,131,000, and B.S. i P.G. Gazoprojekt S.A. acquired 2,000 shares, with a par value of PLN 1,000 per share and the aggregate value of PLN 2,000,000. POWISLE PARK Sp. z o.o. was registered with the National Court Register on March 18th 2009.

Directors' Report on PGNiG Group's Operations in 2008

The chart below presents the consolidated companies within the PGNiG Group as at December 31st 2008 (by operating segments).

PGNiG GROUP'S CONSOLIDATED COMPANIES



Directors' Report on PGNiG Group's Operations in 2008

The Poszukiwania Nafty i Gazu Kraków Group comprises Poszukiwania Nafty i Gazu Kraków Sp. z o.o. and its subsidiary, Oil Tech International F.Z.E.

The GEOFIZYKA Kraków Group comprises Geofizyka Kraków Sp. z o.o. and its subsidiary, GEOFIZYKA Kraków Libya JSC.

Polskie LNG Sp. z o.o. was sold in December 8th 2008.

In 2008, there were no changes in the Company's or the Group's basic management policies.

3. Equity Links

The table below presents other related undertakings of the PGNiG Group as at December 31st 2008.

		Share capital (PLN)	Shareholding of PGNiG S.A. (PLN)	% of share capital held by PGNiG S.A.	% of the total vote held by PGNiG S.A.
Related undertakings of PGNiG S.A.					
1	System Gazociągów Tranzytowych EUROPOL GAZ S.A.	80,000,000.00	38,400,000.00	48.00%	48.00%
2	GAS-TRADING S.A.	2,975,000.00	1,291,350.00	43.41%	43.41%
3	InterTransGas GmbH (EUR) ¹⁾	200,000.00	100,000.00	50.00%	50.00%
4	Polskie Elektrownie Gazowe Sp. z o.o. in liquidation	2,500,000.00	1,212,000.00	48.48%	48.48%
5	Dewon Z.S.A. (UAH) ¹⁾	11,146,800.00	4,055,205.84	36.38%	36.38%
6	Przedsiębiorstwo Inwestycyjne GAZOTECH Sp. z o.o.	1,203,800.00	65,000.00	69.44%	46.30%
7	Sahara Petroleum Technology llc (RO) ¹⁾	150,000.00	73,500.00	49.00%	49.00%
8	PFK GASKON S.A.	13,061,325.00	6,000,000.00	45.94%	45.94%
9	GAZOMONTAŻ S.A.	1,498,850.00	677,200.00	45.18%	45.18%
10	ZRUG Sp. z o.o. (Poznań)	3,781,800.00	1,515,000.00	40.06%	41.71%
11	ZWUG INTERGAZ Sp. z o.o.	4,700,000.00	1,800,000.00	38.30%	38.30%
12	ZRUG TORUŃ S.A.	4,150,000.00	1,300,000.00	31.33%	31.33%
13	TE-MA WOC Małaszewicze Terespol Sp. z o.o. in liquidation	262,300.00	55,000.00	20.97%	21.32%
14	H.S. Szczakowa S.A. in bankructy	16,334,989.44	5,439,494.72	33.30%	33.30%
15	TeNET 7 Sp. z o.o. in liquidation	50,000.00	5,000.00	10.00%	10.00%
Related undertakings of PGNiG S.A. subsidiaries					
		Share capital (PLN)	Shareholding of PGNiG S.A. subsidiaries (PLN)	% of share capital held by PGNiG S.A. subsidiaries	% of the total vote held by PGNiG S.A. subsidiaries
1	NAFT - TRANS Sp. z o.o. in bankructy	2,259,500.00	2,252,500.00	99.69%	99.69%
2	Gazobudowa Poznań Sp. z o.o.	332,600.00	163,000.00	49.00%	49.00%
3	Gazobudowa Kraków Sp. z o.o.	79,500.00	37,500.00	47.20%	47.20%
4	NAFTEK Sp. z o.o. in liquidation	5,000.00	2,200.00	44.00%	44.00%
5	Przedsiębiorstwo Badawczo - Usługowe Petromin Sp. z o.o.	200,000.00	80,000.00	40.00%	40.00%
6	Geotermia Sp. z o.o.	4,000.00	1,000.00	25.00%	25.00%

¹⁾ Figures shown in foreign currencies.

On May 29th 2008, a share capital increase at ZRUG Zabrze Sp. z o.o. was registered with the National Court Register. The company's share capital was increased by PLN 2,500,000 to

PLN 5,250,000. PGNiG S.A. did not participate in the share capital increase and, consequently, the Company's share in the share capital of ZRUG Zabrze Sp. z o.o. decreased to 11.43%;

Changes Subsequent to the End of the Financial Year

On April 5th 2009, GEOFIZYKA Toruń Sp. z o.o. and Al-Mashariq Trading & Contracting Company established a joint venture in the form of a limited liability company under the name of Al Mashariq - Geofizyka Torun Limited Company, with the share capital of SAR 500,000 (Saudi riyals). GEOFIZYKA Toruń Sp. z o.o., a PGNiG S.A. subsidiary, acquired shares in the new company with a value of SAR 250,000, conferring the right to 50% of the total vote at the General Shareholders Meeting. The core business activity of the company comprises provision of geophysical services in Saudi Arabia and other Middle East countries.

Investments Outside the Group of Related Companies

On June 18th 2008, the Management Board of Zakłady Azotowe w Tarnowie-Mościcach S.A. allotted to PGNiG S.A. 4,000,001 Series B shares with a par value of PLN 5.00 and the issue price of PLN 19.50 per share, representing 10.23% of the share capital of Zakłady Azotowe w Tarnowie-Mościcach S.A. The increase in the share capital of Zakłady Azotowe w Tarnowie-Mościcach S.A. was registered with the National Court Register on July 22nd 2008. The total value of the investment was PLN 78m.

As at December 31st 2008, the total nominal value of the PGNiG S.A. Group's capital exposure outside the group of related companies was PLN 56.8m.

4. Employment

The table below presents the employment at the PGNiG Group's consolidated companies as at December 31st 2008, by segments. PGNiG S.A.'s Head Office provides services to all segments. Accordingly, it is disclosed separately.

Employment by segments (no. of staff)

	2008	2007
Head Office	837	604
Exploration and Production	10,725	10,151
Trade and Storage	3,793	3,810
Distribution	13,746	13,538
Other activities	2,044	1,928
Total	31,145	30,031

In the period from January 1st 2000 to December 31st 2008, the PGNiG Group implemented the "Programme of Employment Restructuring and Employee Protection Measures for PGNiG S.A. Branches and Subsidiaries". Under the programme, 21,551 employees were covered by various forms of employment restructuring. The headcount at PGNiG S.A. and its subsidiary undertakings was reduced by 14,689 staff (including the transfer of 2,181 employees as part of the spin-off of OGP Gaz-System Sp. z o.o.).

On December 11th 2008, the Extraordinary General Shareholders Meeting of PGNiG S.A. adopted the Programme for Streamlining of Employment and Redundancy Payments to the Employees of the

PGNiG Group for 2009–2011 (phase III). The programme came into force in January 2009. Contrary to the previous employment restructuring programmes, it is based on a “stand-by” formula. It may be implemented in special circumstances and requires the application by the individual Group members of procedures uniform across the PGNiG Group. The programme may be implemented only when it is justified by the scale of the planned restructuring measures resulting in workforce trimming and/or closing down of posts.

5. Gas Sales and Procurement

In 2008, the PGNiG Group recorded sales revenue of PLN 18.4bn, with 89% of that figure derived from sales of natural gas.

Sales revenue (PLNm)

	2008	2007
Natural gas, including:	16,400.1	14,645.5
- high-methane gas	15,056.4	13,390.1
- nitrogen-rich gas	1,343.7	1,255.5
Crude oil	775.6	777.9
Condensate	3.0	1.7
Helium	27.6	30.5
Propane-butane	42.6	43.7
Geophysical and geological services	360.8	371.6
Reserve exploration services	443.4	377.7
Other sales	378.9	403.6
Total	18,432.0	16,652.1

In 2008, the PGNiG Group sold 13.7bn m³ of natural gas, with 96% of that figure accounted for by revenues from the transmission and distribution systems and the balance – by direct sales of natural gas from deposits.

Natural gas sales volume (million m³)

	2008	2007
Trade and Storage	13,119.1	12,974.8
Exploration and Production	611.2	628.7
Total	13,730.3	13,603.5

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In 2008, the volume of natural gas acquired by the PGNiG Group reached 14.4bn m³, with 72% of that amount sourced from imports, mostly from Russia and the Middle East. Natural gas production from domestic deposits represented 28% of the total volume acquired. The table below sets forth the structure of natural gas procurement and production measured as high-methane gas equivalent.

Natural gas procurement and production (million m³)

	2008	2007
Imports	10,264.3	9,286.0
Domestic production	4,073.9	4,276.1
Domestic suppliers	22.1	15.8
Total	14,360.3	13,577.9

Chapter II: Regulatory Environment

The key laws regulating the activities of the PGNiG Group are:

- Polish Energy Law of April 10th 1997 (consolidated text: Dz.U. of May 30th 2006, No. 89, item 624, as amended) – with respect to the activities in the area of trade in gaseous fuels, gas distribution and storage of gaseous fuels.
- Act on Reserves of Crude Oil, Petroleum Products and Natural Gas, as well as Rules of procedure to be followed when the state's fuel security is threatened or the petroleum market is disturbed, dated February 16th 2007 (Dz.U. of March 23rd 2007, No. 52, item 343, as amended) – with respect to the activities in the area of international trade in natural gas.
- Polish Geological and Mining Law of February 4th 1994 (Dz.U. of March 1st 1994, No. 27, item 96, as amended) – with respect to production activities and related sales of gas.

1. Polish Energy Law

The activities of the PGNiG Group in the area of trade in gaseous fuels are regulated and require a licence granted and tariff approved by the President of URE. The tariff specifies prices of gaseous fuels.

The amendments to the Polish Energy Law introduced in June 2007 required that secondary legislation be adopted so as to enable the preparation of a tariff for the comprehensive service. On February 20th 2008, the Regulation of the Minister of Economy and Labour on detailed rules for preparing and calculating tariffs for gaseous fuels and on settlements in gaseous fuels trade (Dz. U. of February 20th 2008, No. 28, item 165) became effective. As the regulation was signed in February, the Company had to change its tariff application submitted in November 2007, which protracted the proceedings for approval of the tariff for gaseous fuels.

2008 saw continuation of the work on further changes to the Polish Energy Law and the Regulation of the Minister of Economy and Labour on detailed rules for functioning of the gas system was prepared and submitted for public consultations. By the date of preparation of this Directors' Report, the above instruments had not been implemented.

1.1. Licences

In 2008, the President of URE issued decisions on the expiry of the following licences granted to the Gas Trading Companies:

- six licences for trade in gaseous fuels (February 2008),
- two licences for international trade in natural gas (February 2008),
- one licence for trade in liquid fuels (September 2008),

as a result of the Companies' deletion from the relevant register.

On September 16th 2008, the President of URE issued a decision granting PGNiG S.A. an energy production licence, effective until September 18th 2018. The licence covers business activities consisting in electricity co-generation from a single source, to be carried out in Świdnik Duży, the Lublin province. On January 22nd 2009, the President of URE issued a decision expanding the licence by a source situated in Rzeszów, the Rzeszów province.

On November 17th 2008, the Company applied to the President of URE for appointment as the Storage System Operator. In the decision of December 31st 2008, the President of URE appointed PGNiG S.A. as the Storage System Operator for the area specified in the licence, excluding the part of the storage system used for production and the part used exclusively to perform the tasks of the Transmission System Operator, for the period January 1st 2009 – December 31st 2025.

As at December 31st 2008, the Company held the following licences granted by the President of URE under the Energy Law:

- one licence for transmission and distribution of gaseous fuels
- one licence for trade in gaseous fuels
- one licence for international trade in natural gas
- one licence for storage of gaseous fuels
- two licences for trade in liquid fuels
- one licence for electricity production

1.2. Tariff Policy

The crucial factor determining PGNiG Group's regulated business is the dependence of the Group's revenue on tariffs which are subject to approval by the President of URE. Tariff prices are crucial for the Company's ability to generate revenue that can cover the incurred justified costs plus return on capital employed. The gas prices are directly connected with the applied tariff preparation methodology.

The tariff preparation methodology is based on the determination of prices and charge rates against forecast costs and gas sales targets. In accordance with the guidelines issued by the regulatory authority (the President of URE), calculation of prices of gaseous fuels included the cost of acquisition of natural gas from all sources, that is of both imported and domestically produced gas. In practice this means that both international trade and domestic production are subject to regulated pricing. Given that the current prices of imported gas are higher than those of domestically produced gas, the inclusion of production cost for gas from domestic sources in the cost basket, taken into account in pricing, resulted in a situation where the tariff prices (applicable in settlements with customers) were determined below the level that would have been set based on the cost of acquisition of imported gas.

In the settlements with customers with which PGNiG S.A. had concluded agreements for sale of gaseous fuels with the delivery to points of acceptance were regulated by the settlement rules and charge rates specified in subsequent tariffs approved by the President of URE.

1.3. Changes in PGNiG S.A.'s Tariffs

On March 28th 2008, the President of URE issued a decision whereby PGNiG S.A. was released from the obligation to submit for approval tariffs for compressed natural gas, used as fuel in motor vehicles.

Until April 24th 2008, settlements with customers were made according to Tariff No. 4 for Gaseous Fuels approved by the President of URE on March 17th 2006.

On November 15th 2007, PGNiG S.A. applied to the President of URE for approval of the Gaseous Fuel Tariff No. 1/2008 of Polskie Górnictwo Naftowe i Gazownictwo S.A. for the period from January 1st 2008 to March 31st 2008. On February 20th 2008, the Regulation of the Minister of Economy and Labour on detailed rules for preparing and calculating tariffs for gaseous fuels and on settlements in gaseous fuels trade (Dz.U. of February 20th 2008, No. 28, item 165) became effective, which necessitated changes in the application. On February 20th 2008, the Company amended the application in order to bring it to compliance with the new Tariff regulation.

Under his decision of April 10th 2008, the President of URE approved the Gaseous Fuel Tariff No. 1/2008, in effect from April 25th 2008. The tariff provides for:

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- the prices, subscription fees and network rates applicable to settlements with customers receiving gaseous fuels from the transmission grid,
- the prices, subscription fees and network rates applicable to settlements with customers receiving gaseous fuels from distribution networks.
- the manner of determining charges for failure to maintain quality parameters for gaseous fuels and quality standards in customer service, and the manner of determining the discount for exceeding the contractual capacity.

The introduction of network rates is a material modification in the tariff. These rates are calculated based on fixed and variable costs incurred in connection with the Company's contracting services for gas transmission, distribution, storage and liquefying, and liquefied natural gas regasification, as well as costs of storage in the Company's own facilities and cost of system balancing and system limitation management.

Moreover, the tariff defines the manner for determination of the charge for exceeding the contractual capacity and of the discount for failure to maintain quality parameters for gaseous fuels and quality standards in customer service.

PGNiG S.A.'s tariff is applied in gaseous fuel supplies under such comprehensive agreements or gaseous fuel sale agreements concluded prior to the tariff effective date, whose performance requires PGNiG S.A. to mandate a third party to transport gaseous fuel over the transmission grid or a distribution network, or to use storage facilities. Under a comprehensive agreement, PGNiG S.A. undertakes not only to sell gaseous fuel to customers but also to ensure its delivery to the delivery point specified by the customer.

On August 12th 2008, PGNiG S.A. applied to the President of URE for approval of an amendment to Gaseous Fuel Tariff No. 1/2008, necessitated by PGNiG's changed business conditions, namely the increase in gas acquisition cost above the level assumed for the calculation of prices in the approved tariff; and for adjustment of the wording of the tariff. The amendment was intended to ensure harmonisation of the provisions of Gaseous Fuel Tariff No. 1/2008 with provisions of the tariffs of the Transmission System Operator and Distribution System Operators.

By virtue of the decision of October 17th 2008, the President of URE approved the amendments to Gaseous Fuel Tariff No. 1/2008. The tariff has been used in settlements with customers since November 1st 2008.

The table below sets forth the prices and rates applied in settlements with customers receiving gaseous fuels from the transmission grid.

Tariff Group	Price of gaseous fuel	Subscription fee
	[PLN/m ³]	[PLN/month]
E1A-E4B	0.9983	600.00
Ls1-Ls4	0.6327	600.00
Lw1-Lw4	0.7385	600.00

The tables below set forth the prices and rates applied in settlements with customers receiving gaseous fuels from the distribution network, by tariff groups:

- High-methane natural gas (E groups)

Tariff Group	Price of gaseous fuel	Subscription fee
	[PLN/m ³]	[PLN/month]
W-1	1.0500	4.30
W-2	1.0350	6.40
W-3	1.0215	7.10
W-4	1.0160	18.00
W-5	1.0100	110.00
W-6	1.0011	130.00
W-6A	1.0011	130.00
W-6B	1.0011	130.00
W-7	0.9993	270.00
W-7A	0.9993	270.00
W-7B	0.9993	270.00
W-8	0.9988	600.00
W-9	0.9988	600.00
W-10	0.9988	600.00

- Nitrogen-rich natural gas (Ls subgroups)

Tariff Group	Price of gaseous fuel	Subscription fee
	[PLN/m ³]	[PLN/month]
Z-1	0.6659	4.30
Z-2	0.6564	6.40
Z-3	0.6474	7.10
Z-4	0.6444	18.00
Z-5	0.6404	110.00
Z-6	0.6344	130.00
Z-7	0.6333	270.00
Z-7A	0.6333	270.00
Z-7B	0.6333	270.00
Z-8	0.6329	600.00
Z-9	0.6329	600.00

- Nitrogen-rich natural gas (Lw subgroups)

Tariff Group	Price of gaseous fuel	Subscription fee
	[PLN/m ³]	[PLN/month]
S-1	0.7770	4.30
S-2	0.7660	6.40
S-3	0.7560	7.10
S-4	0.7520	18.00
S-5	0.7481	110.00
S-6	0.7410	130.00
S-7	0.7397	270.00
S-7A	0.7397	270.00
S-7B	0.7397	270.00
S-8	0.7393	600.00
S-9	0.7393	600.00

On February 13th 2009, PGNiG S.A. applied to the President of URE for approval of Gaseous Fuel Tariff No. 1/2009 (during the proceedings the tariff's name was changed to Gaseous Fuel Tariff No. 2/2009). By the date of this Report, no decision had been issued by the President of URE regarding the tariff.

1.4. Changes in the Tariffs of Gas Companies

Until April 24th 2008, settlements with customers receiving gaseous fuels from the Gas Companies were made according to Gaseous Fuel Tariff No. 2/2006, approved by the President of URE on March 17th 2006.

In his decision of April 10th 2008, the President of URE approved the Tariff for Gaseous Fuel Distribution Services effective from April 25th 2008 and specifying:

- charge rates for gaseous fuel distribution services and subscription fees,
- manner for determination of fees for connecting to the high-pressure network, as well as of fees for connecting to medium- and low-pressure networks.

Moreover, the tariff defines the manner for determination of the charges for exceeding the contractual capacity, illegal draw of gaseous fuels and failure to comply with the imposed limitations, as well as of the discount for failure to maintain quality standards in customer service.

1.5. Regulatory Risks

Regulatory Risk

The key tariff risk relates to the inadequacy of secondary legislation with regard to the current legal acts concerning the Polish gas market. Such a situation occurred at the turn of 2007, when the lack of a Tariff regulation amended in accord with the amended Polish Energy Law delayed the proceedings

related to the approval of the Gaseous Fuel Tariff. The Minister of Economy signed the tariff regulation as late as in February 2008. However, another regulation, crucial for the operation of the gas market and outlining detailed terms of the gas system operation (system regulation), is being drafted.

In 2009, further amendments may be made to the legal acts regulating operation of the gas sector. These amendments should be made, first and foremost, to the Polish Energy Law. Once the amended Law becomes effective, the tariff regulation will need to be amended.

Changes in the legal environment gradually implemented in connection with Poland's accession to the European Union may not allow for the nature of the PGNiG Group's business. Further legal changes affecting the operation of gas companies may be introduced in following years. Legal changes, including delays in amendments to legal acts, create risks relating to business adaptation to such changes, which might adversely affect the PGNiG Group's business, financial results and growth prospects.

Calculation Risk

PGNiG S.A.'s ability to cover costs of its core operating activities depends on the prices approved by the President of URE. While approving tariffs for a given period, the President of URE considers other external factors which are beyond PGNiG S.A.'s control. In an attempt to protect weaker customers, while verifying costs of operating activities, the President of URE may consider certain cost unjustified or may reject the assumptions adopted by PGNiG S.A. with respect to main drivers of cost changes and profit targets allowing for business risk. The URE may also refuse to accept tariff prices and charge rates applied for by PGNiG S.A. Lower tariff prices and charges might adversely affect PGNiG S.A.'s profitability.

Forecasting Risk

The current methodology for calculation of prices and charge rates is based on forecast values; accordingly, revenue is encumbered with forecasting risk. Inaccurate estimates of demand affecting the accuracy of forecast purchase and supply volumes, as well as the value of costs on which the determinations of prices and charge rates are based may adversely affect financial results. An increase in demand above the forecast level would necessitate additional purchases under all existing contracts (in numerous cases, at prices higher than those forecast).

Market Risk

Prices of imported gas are determined 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 acquisition cost of imported gas. The market of crude oil and petroleum products has recently been to a large extent unpredictable, given the continual price changes. These material changes in fuel prices on the international markets affect the prices of imported gas. Each, even accurate forecast of changes of natural gas prices is encumbered with a high error risk. There can be no assurance that, despite legal possibility of adjusting the prices approved for a tariff term, an increase in the price of imported gas may not be fully passed on customers or the changes in selling prices may lag behind the changes in import prices.

Risk of Competition

In recent years, the increase in prices of fuels on global markets has led to increased interest in exploration activities. There is a risk of competition from other companies active on the Polish market seeking licenses for exploration and prospecting of deposits or the implementation of a strategy

providing for acquiring access to own hydrocarbon reserves. At present, competition in the domestic market is limited. However, after having been granted relevant licenses, PGNiG S.A.'s competitors will enter the Polish market. A strong competitive edge may be gained especially by large companies which enjoy established positions on the international markets and have access to much greater financial resources compared with PGNiG S.A., helping them to accept the high risk of exploration activities in Poland.

2. Act on Reserves of Crude Oil, Petroleum Products and Natural Gas

The Act on Reserves of Crude Oil, Petroleum Products and Natural Gas, as well as Rules of procedure to be followed when the national fuel security is threatened or the petroleum market is disturbed regulates the issues related to ensuring the national fuel security, including the rules for creating, maintaining, and financing the reserves of natural gas by those energy companies whose business involves international trade in natural gas or which are importing gas for their own needs. The Act introduces certain changes with respect to the business activity conducted by PGNiG S.A.:

- It sets the timetable for creation of mandatory stocks of natural gas; it stipulates that in 2012, the volume of mandatory stocks will cover 30 days' average daily imports of gas;
- It provides for return on capital employed in storage activity of at least 6%;
- It stipulates that cost related to maintaining, releasing and supplementing reserves is justified operating cost within the meaning of Art. 3.21 of the Polish Energy Law.

3. Polish Geological and Mining Law

The Polish Geological and Mining Law of February 4th 1994 (Dz.U. 05.228.1947) defines the rules and conditions for:

- carrying out geological work,
- extracting minerals from reserves,
- storing waste matter in rock mass, including in worked-out caverns,
- protection of mineral reserves, underground waters and other environmental resources 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 and prospecting for mineral reserves, extraction of minerals from reserves, 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 the supervision of competent geological administration and mining supervision authorities. The Geological and Mining Law provides for criminal sanctions in case of failure to comply with its regulations and specifies the upper and lower limits of mining fees.

In 2008, the Ministry of Natural Environment granted PGNiG S.A. eight licences for exploration and prospecting of crude oil and natural gas reserves, and extended the term of 31 licences. In 2008, eight licences for crude oil and natural gas production were obtained, while four licences expired. In addition, during the year two licences for underground gas storage were granted, while one such licence expired. No changes occurred with respect to licences for waste matter storage in the reporting period.

As at December 31st 2008, PGNiG S.A. held the following licences, granted on the basis of the Geological and Mining Law:

- 75 licences for exploration and prospecting of crude oil and natural gas reserves;
- 217 licences for production of crude oil and natural gas from reserves;
- 9 licences for underground gas storage;
- 4 licences for waste matter storage.

Chapter III: Exploration and Production

The segment's key activity is the production of hydrocarbons from deposits and preparation of products for sale. The segment covers the entire process of exploration and production of natural gas and crude oil, starting from geological analyses, through geophysical studies and drills, to the development and operation of deposits. For its own purposes, the segment also partially uses the capacity of the Underground Storage Facilities in Brzeźnica, Strachocina and Swarzędów.

In 2008, the exploration and production segment was mostly engaged in off-tariff sales of natural gas, as well as sales of crude oil and other products. The main customers for natural gas represented the industrial sector, which accounted for 85.9% of the total sales volume. The table below sets forth the sales volumes of key products to external customers.

Sales of key products of the PGNiG Group

	Unit	2008	2007
1. Natural gas, including:	million m ³	611.2	628.7
- high-methane natural gas	million m ³	47.2	50.2
- nitrogen-rich natural gas*	million m ³	564.0	578.5
2. Crude oil	thousand tonnes	497.2	540.7
3. Condensate	thousand tonnes	1.2	1.1
4. Helium	million m ³	2.2	2.4
5. Propane-butane mix	thousand tonnes	17.4	18.4
6. Nitrogen	thousand kg	1,221.0	421.7
7. Sulphur	thousand tonnes	20.3	23.4

* Million m³ measured as high-methane gas equivalent.

In December 2008, PGNiG S.A. and Zakłady Azotowe of Tarnów-Mościce S.A. signed an agreement for sale of nitrogen-rich gas from the Rylowa, Rajsko, Szczepanów and Wierzchosławice fields. The agreement was signed for 12 years and provides for supplies of approximately 50m m³ p.a., starting from 2012.

In 2008 the Company executed agreements for the supply of crude oil to refineries of the Orlen Group, including Rafineria Trzebinia S.A. and Rafineria Nafty Jedlicze S.A. As far as supplies via pipelines are concerned, the agreement concluded with BP International for the sale of crude oil abroad was replaced with an agreement with TOTSА TOTAL OIL TRADING S.A. The terms of export sales of crude oil remain unchanged.

1. Exploration

In 2008, the PGNiG Group conducted work related to exploration and prospecting for hydrocarbon reserves, as part of which it performed 310,058.5 m of drillings, 8,046.7 km of 2D seismic surveys and 6,191.5 km² of 3D seismic surveys. The projects were performed both within the PGNiG Group licences and for external companies domestically and abroad.

1.1. Exploratory Work in Poland

For PGNiG S.A., a total of 65,347 m of drillings were made in Poland, in the Carpathians, Carpathian Foreland and Polish Lowlands. Drilling work covered 35 boreholes, including 24 exploratory boreholes and 11 prospecting boreholes. At six of the boreholes, drilling commenced in 2007. From among the 30 boreholes with known deposit-related results, 11 (ten gas boreholes and one crude oil borehole) were classified as positive, while 19 other boreholes were classified as negative. Furthermore, a total of 1,538.5 km of 2D seismic surveys and 602.6 km² of 3D seismic surveys were performed.

As at December 31st 2008, the volumes of proved reserves approved by the Minister of Environment was:

- 93.3bn m³ of natural gas measured as high-methane gas equivalent,
- 21m tonnes of crude oil.

In 2009, a 9.2bn m³ increase in producible reserves of natural gas (measured as high-methane gas equivalent) and a 230 thousand tonnes increase in producible reserves of crude oil are expected to be proved (respective figures as at December 31st 2008).

In 2008, PGNiG S.A. continued joint projects with FX Energy Poland Sp. z o.o. in the following areas: Płotki, Płotki-PTZ, Poznań and Blok 255; it also continued to cooperate with Eurogas Polska Sp. z o.o. and Energia Bieszczady Sp. z o.o. in the Bieszczady area.

1.2. Exploratory Work Abroad

In 2008, the PGNiG Group conducted work in licence areas in Norway, Libya, Pakistan, Denmark and Egypt.

Pakistan

PGNiG S.A. conducts exploratory work in Pakistan under an agreement between PGNiG S.A. and the Pakistani government dated May 18th 2005, concerning exploration and production of hydrocarbons in the area covered by the Kirthar licence. Exploratory work in the Kirthar block area is conducted in cooperation with Pakistan Petroleum Ltd. (interests/project cost participation: PGNiG S.A. – 70%; PPL – 30 %). Owing to the lack of relevant equipment, drilling of first exploration borehole Rahman-1 has been postponed until Q2 2009.

Denmark

On December 6th 2007, PGNiG S.A. executed an agreement concerning assignment of an interest in the 1/05 exploration licence in Denmark and took over the operator functions. Interests held in the license: PGNiG S.A. – 40%, Odin Energi A/S – 40%, Nordsofonden – 20%. On April 5th 2008, by virtue of the decision of the Danish Energy Agency, the licence was extended until October 5th 2009, contingent on performing a 3D seismic shot covering an area of not less than 50 km². In 2008 archival 2D seismics has been reprocessed with a view to locating the 3D shot, whose performance is planned for 2009.

Egypt

In 2007, PGNiG S.A. won a tender for the Bahariya exploration license (Block 3) in Egypt. The licence covers an area of 4,414.4 km². In July 2007, the Production Sharing Agreement was initialled. PGNiG S.A. will commence the performance of the licence agreement pending the ratification of the PSA by the Egyptian Parliament and its subsequent execution by the parties. In 2009, 1,450 km of 2D seismics is planned to be reprocessed.

Iran

In February 2008, PGNiG S.A. signed a letter of intent with Iranian Offshore Oil Company (IOOC) for development of the Lavan gas and condensate deposit.

2. Production

Two of PGNiG S.A.'s branches, the Zielona Góra Branch and the Sanok Branch, carry out production of natural gas and crude oil in Poland. The Zielona Góra Branch produces crude oil and nitrogen-rich natural gas at 20 mines (including 12 gas mines, and 8 oil and gas mines), while the Sanok Branch produces high-methane natural gas, nitrogen-rich natural gas and crude oil at 46 mines (including 26 gas mines, and 20 oil mines and oil and gas mines).

In 2008, PGNiG S.A. produced a total of 4,073.9m³ of natural gas (high-methane equivalent) and 487.4 thousand tonnes of crude oil. 2008 saw a 4.7% decrease in natural gas production over the 2007 figures. The decrease was caused by the natural fall in production capacity of the operated boreholes and less than expected volume of reserves of the fields being developed. Over the same time, the production of crude oil dropped by 5.9% owing to decreased production capacity and a technical failure at the Dębno mine. The table below sets forth PGNiG S.A.'s production in 2008.

Production structure

	Unit	2008	2007
1. Natural gas	million m ³ *	4,073.9	4,276.1
- Zielona Góra Branch	million m ³ *	2,297.4	2,391.0
- Sanok Branch	million m ³ *	1,776.5	1,885.1
2. Crude oil	thousand tonnes	487.4	518.2
- Zielona Góra Branch	thousand tonnes	442.5	472.0
- Sanok Branch	thousand tonnes	44.9	46.2
3. Condensate	thousand tonnes	11.2	9.6
4. Sulphur	thousand tonnes	21.3	23.3
5. Propane-butane mix	thousand tonnes	17.4	18.2
6. Helium	million m ³	2.2	2.3
7. LNG	million m ³ *	20.1	21.7

* High-methane equivalent

In 2008, a total of 16 boreholes were put in operation in the Sanok Branch area; in the case of the Zielona Góra Branch, two new boreholes were commissioned. The new boreholes increased the natural gas production capacity by ca. 510 m³/min.

In 2008, PGNiG S.A. conducted a number of projects aiming to maintain natural gas and crude oil production from the existing fields. In order to increase hydrocarbon production, 7,772 m of operational drill holes were performed. In 2008, drilling of ten operational drills was completed in the following fields: Radlin, Sędziszów, Dzieduszyce, Cierpisz, Bonikowo, Strachocina, Rudka and Trzebowniko. With a view to limiting the natural decline in production, 42 non-producing boreholes were overhauled. Flow-rate intensification measures were taken to maintain or increase the production capacity of the operational boreholes.

In connection with the pressure decrease on the reserves in Palikówka and Kuryłówka, it was necessary to install compressors at interconnector terminal points. This prevented decommissioning of certain boreholes and enabled transfer of the produced gas to the transmission system. There are plans to install two more compressors on the Jodłówka reserve in 2009.

The exploration and production segment uses the Underground Storage Facilities in Brzeźnica, Strachocina and Swarzędów, to secure the necessary storage capacity to handle the produced gas during the low-demand periods. Besides, the underground storage facilities enable optimum production from domestic deposits during the year and provide tools for rational management of natural gas reserves. The table below sets forth the available capacities of the underground storage facilities as at the end of 2008.

Available capacities of the underground storage facilities used by the exploration and production segment

	million m ³
Brzeźnica	65.0
Strachocina	150.0
Swarzędów	90.0

In 2008, PGNiG S.A. worked on extending the existing Underground Storage Facility in Strachocina (for storing high-methane natural gas) to increase the available capacity to 330m m³, and on constructing the new underground storage facilities in Daszewo (for nitrogen-rich natural gas Ls) and Bonikowo (for nitrogen-rich natural gas Lw). The nitrogen-rich gas storage facilities are to help optimise the production of Ls nitrogen-rich gas from local sources in the seaboard region (Daszewo) and the production of Lw nitrogen-rich gas from sources in western Poland (Bonikowo).

3. Planned Exploratory Work

Exploratory Work in Poland

In 2009, PGNiG S.A. plans to conduct geophysical and drilling works at 29 exploratory boreholes (work at six boreholes to be conducted in cooperation with foreign companies) and at seven prospecting boreholes.

Exploratory Work Abroad

In 2008, the PGNiG Group took a number of steps to acquire new sites for exploration and new licence areas in such countries as Algeria, Iraq, Iran, Morocco, Mongolia and Tunisia. All these efforts will be continued in 2009. Furthermore, the PGNiG Group plans to press ahead with the exploratory work in the licence areas in Norway, Denmark, Egypt, Libya and Pakistan.

Underground Gas Storage Facilities

In 2009, PGNiG S.A. will proceed with the construction of the surface installations of the Daszewo facility. The Company also plans to commence construction work of the surface infrastructure for the gas storage facilities in Strachocina and Bonikowo.

Natural Gas Production

PGNiG S.A. is following an investment programme aimed at increasing, in a longer perspective, the natural gas production capacity. As part of the programme, the Company plans to develop new reserves and boreholes, modernise and expand the existing natural gas mines, and build new underground gas storage facilities and expand the existing ones. Moreover, PGNiG will take steps to maintain the volume of hydrocarbons production from fields already in use at the current levels.

The plans for 2009 assume a natural gas production volume of 4.3bn m³ annually (high-methane equivalent) with a calorific value of 39.5 MJ/m³, which is to go down from the previously assumed production volume of 4.6bn m³. The lower volume of the forecast production is attributable to a decline in demand for nitrogen-rich gas from industrial customers receiving gas directly from deposits. It is also due to the rescheduling of the capex plans related to development of new gas fields and a natural decrease in the production capacities from the reserves already in use. In order to improve the production volume to approx. 4.5bn m³, in the next few years PGNiG S.A. intends to develop and commence production on a number of documented natural gas deposits, including in Wielichowo-Ruchocice, Roszków and Międzychód (nitrogen-rich gas reserves in western Poland) as well as in Łukowa, Jasionka – Phase II, Kupno, Pilzno – Phase II and Rudka – Phase II (high-methane gas reserves in the Province of Rzeszów).

2010 is to see completion of the project of Grodzisk Nitrogen-Removal Plant, with the annual throughput capacity of feedstock gas amounting to 500m m³. The project provides for development of the reserves located in the Nowy Tomyśl-Grodzisk region and of the gas extracted from the Lubiatów-Międzychód-Grotów (LMG) reserves, as well as the construction of a second controller, besides the Odolanów Branch, connecting the system for extraction of nitrogen-rich gas to the high-methane gas transmission network.

Crude Oil Production

In August 2008, PGNiG S.A. signed a PLN 1.4bn contract with the consortium of Poland's PBG S.A., Italy's Technip KTI S.P.A. and Canada's Thermo Design Engineering Ltd. to carry out the project "LMG Project – Central facilities, borehole areas, pipelines and other infrastructure". The commencement of work is scheduled for 2009.

Development of the Lubiatów-Międzychód-Grotów (LMG) reserve and intensified production from the Barnówko-Mostno-Buszewo (BMB) reserve are two projects aimed at increasing PGNiG's crude oil production output. The Company plans that in 2009 the crude oil production will reach more than 500 thousand tonnes. A significant increase in crude oil production is expected in 2013, when the LMG reserve is developed and placed in operation, and is to amount to approx. 0.9m tonnes annually.

4. Exploration and Production Companies

PNiG Jasło Sp. z o.o.

The core business of Poszukiwania Nafty i Gazu Jasło Sp. z o.o. consists in execution of exploratory and production boreholes, reconstruction and liquidation of boreholes and performance of specialist drilling services, including cementing, flushing, borehole reinforcement, as well as servicing of control and instrumentation at well surface installations.

In 2008, the company's sales revenue was PLN 281.9m, of which the revenue from services provided to the PGNiG Group accounted for 73%. PNiG Jasło Sp. z o.o.'s main customer in Poland was PGNiG S.A. The company also executed boreholes for RWE Dea Polska Sp. z o.o., drilled a geothermal borehole for the Lux Veritatis Foundation, and provided cementing and packer services to external customers, such as PRWiG, FX Energy Poland Sp. z o.o. and Petrobaltic S.A. Outside Poland, the company performed drilling work in Libya and geothermal drilling work in Germany. In Lithuania,

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Latvia and Ukraine, PNiG Jasło Sp. z o.o. performed specialist services in the area of reconstruction and drilling, and cementing, as well as Datawell services.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	281.9	236.3
Net profit (loss)	PLNm	18.2	9.2
Equity	PLNm	142.0	127.6
Total assets	PLNm	219.6	194.1
Headcount as at December 31st	person	932	861

In 2009 and beyond, Poland will remain PNiG Jasło Sp. z o.o.'s nearest strategic market where the company will perform services for PGNiG S.A., with auxiliary markets being Libya, Germany, Russia and Ukraine for oil and geothermal services. In 2009, the company started reconstruction work in Russia and commenced drilling of the second geothermal hole in Germany.

The PNiG Kraków Group

The PNiG Kraków Group is composed of Poszukiwania Nafty i Gazu Kraków Sp. z o.o. and Oil Tech International F.Z.E. The core business of PNiG Kraków Sp. z o.o. consists in geological, exploratory and production drilling, reconstruction of boreholes and servicing related to drilling, sampling and operation of boreholes. The company also provides mine rescue services as well as hospitality, catering, rental and training services. Oil Tech International F.Z.E. provides services consisting in the provision of operator teams, materials, and plant and equipment to PNiG Kraków Sp. z o.o.

In 2008, the PNiG Kraków Group sales revenue reached PLN 360.2m, with revenue from services provided to customers from outside the PGNiG Group accounting for 65% of that figure. Foreign customers represented 62% of the revenue from services provided to external customers. The PNiG Kraków Group provided services in Kazakhstan, Mozambique, Uganda, Latvia and Ukraine. In Poland, the Group performed drilling work and provided maintenance services related to drilling, sampling and operation of boreholes under turn-key contracts, of which the majority was concluded with the PGNiG Group.

Group's highlights

	Unit	2008	2007*
Sales revenue	PLNm	360.2	301.0
Net profit (loss)	PLNm	5.6	17.3
Equity	PLNm	182.5	166.3
Total assets	PLNm	395.3	368.6
Headcount as at December 31st	person	1,344	1,353

* data from PNiG Kraków Sp. z o.o.

In 2009, the PNiG Kraków Group plans to continue executing contracts for drilling service concluded in 2008 in Kazakhstan, Pakistan, Uganda and Ukraine. In addition, the PNiG Kraków Group will continue work on the boreholes situated in Southern Poland, as well as perform probing and directional drilling services under contracts concluded in 2008.

PNiG NAFTA Sp. z o.o.

The core business of Poszukiwania Nafty i Gazu NAFTA Sp. z o.o. comprises exploration of crude oil and natural gas reserves, primarily with respect to design, execution and documentation of research, prospecting, exploratory and production boreholes. The company also provides specialist drilling services, and deals with drilling of boreholes for underground storage of hydrocarbons, liquidation of boreholes in used-up reserves and reconstruction of developed boreholes. In addition, the company provides support services through its workshop specialising in repair of drilling equipment, and storage facilities.

In 2008, the PGNiG Group was the company's key customer in Poland. The exploration work was continued in North-West and Western Poland. The company's total sales revenue stood at PLN 284.7m, with the revenue from the services provided to the PGNiG Group accounting for 77% of that figure. In 2008, the company performed exploration and prospecting drilling work for PGNiG S.A. and drilling work for the underground storage facility in Mogilno, as part of a project carried out by INVESTGAS S.A. Outside Poland, PNiG NAFTA Sp. z o.o. executed drilling work in Egypt, India and Hungary. In 2008, the execution of contracts for drilling work in India was completed.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	284.7	262.0
Net profit (loss)	PLNm	34.6	36.5
Equity	PLNm	180.2	160.9
Total assets	PLNm	318.2	267.1
Headcount as at December 31st	person	773	713

In Poland, PNiG NAFTA Sp. z o.o. will continue drilling work at the underground storage facilities in Mogilno and Kosakowo for PGNiG S.A., and drilling of an exploratory borehole for FX Energy Poland Sp. z o.o. in 2009. Abroad, the company will perform drilling work in Egypt and Hungary.

The GEOFIZYKA Kraków Group

The GEOFIZYKA Kraków Group provides geophysical services in the area of field seismics with use of 2D and 3D sources of vibration- or dynamite-induced excitation, processing and interpretation of seismic data from geophysical surveys, performance of measurements, operations and special work in boreholes, interpretations and perforations. The group also offers drilling seismometry services.

With a view to starting operations in Libya, on January 29th 2008, GEOFIZYKA Kraków Sp. z o.o. established a company under the name of GEOFIZYKA Kraków Libya JSC. GEOFIZYKA Kraków Sp. z o.o. and BARARI Co. For Oil Services became the shareholders of the new entity, acquiring, respectively, 60% and 40% of its share capital. GEOFIZYKA Kraków Libya JSC did not commence its business activity in 2008.

In 2008, GEOFIZYKA Kraków Sp. z o.o.' sales revenue reached PLN 178.8m, with revenue from sales provided to the PGNiG Group accounting for 54%, and revenue from services provided to customers outside the PGNiG Group accounting for 46% of the total. Abroad, the company primarily performed 2D and 3D seismics in the Czech Republic, Denmark, Libya and Pakistan, as well as geophysical drilling services in Latvia, Slovakia and Hungary. Seismic data processing and interpretation was performed for a Czech company Moravské Naftové Doly a.s. The company was also engaged by a Hungarian company MOL for the processing of data obtained during work performed under a license in Yemen. Due to unstable political situation in Pakistan, the execution of

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the contract concluded with ODGCL was suspended in accordance with applicable clauses of the contract. For the same reason, the company decided not to commit itself to execution of the second contract for MOL/Mari Gas.

Group's highlights

	Unit	2008	2007
Sales revenue	PLNm	178.8	226.5
Net profit (loss)	PLNm	0.2	2.1
Equity	PLNm	90.1	64.0
Total assets	PLNm	205.0	202.0
Headcount as at December 31st	person	1,124	874

In 2009, GEOFIZYKA Kraków Sp. z o.o. entered into contracts providing for the performance of seismic work, processing and interpretation on the domestic market, as well as contracts for the performance of field seismics and drilling seismometry services in Slovakia, the Czech Republic and Hungary. In addition, the company won a tender for the performance of 2D and 3D seismics in Murzuq (Libya).

GEOFIZYKA Toruń Sp. z o.o.

GEOFIZYKA Toruń Sp. z o.o. offers geophysical services in the area of seismic surveys, including design work and acquisition of data, digital processing of data and comprehensive geophysical and geological interpretations. The company also provides services in the area of geophysical surveys and operations in boreholes, including their interpretation, as well as drilling services. In addition, GEOFIZYKA Toruń Sp. z o.o.'s offering includes shallow geophysical tests as part of environmental, protection activities, geological and hydrogeological tests, as well as design and installation of deep groundbeds for cathodic protection.

In 2008, GEOFIZYKA Toruń Sp. z o.o.'s sales revenue amounted to PLN 332.4m, 65% of which accounted for revenue from services rendered to customers other than the PGNiG Group's companies (56% of that revenue accounted for export activities). The company's services abroad included acquisition and processing of 2D and 3D seismic data in India, Syria and Germany. In Poland, GEOFIZYKA Toruń Sp. z o.o. mainly carried out work for the PGNiG Group and for FX Energy Poland Sp. z o.o. in the area of design and acquisition of data, processing of data and comprehensive geophysical and geological interpretations.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	332.4	314.6
Net profit (loss)	PLNm	32.2	16.9
Equity	PLNm	168.1	140.7
Total assets	PLNm	252.1	219.3
Headcount as at December 31st	person	1,186	1,213

In 2009, GEOFIZYKA Toruń Sp. z o.o.'s objective will be to strengthen its position on the domestic market and selected foreign markets (India, Iran, Germany, Syria and Thailand) through the expansion

of its service portfolio and optimal utilisation of its resources. The company also plans to launch its services in Turkey, Yemen, Egypt and Saudi Arabia.

PN Diament Sp. z o.o.

The core business of Poszukiwania Naftowe Diament Sp. z o.o. consists in providing specialist drilling services, which include: borehole drilling, repair work, liquidation of boreholes, production sampling of boreholes, deep measurements, production intensification and other work with the use of coiled tubing and a nitrogen unit, as well as borehole reinforcement and drillstem testing with blowout prevention equipment. The company also conducts business activity comprising general construction engineering, road construction and municipal waste dump construction, and it provides vehicle repair, transport and equipment services.

In 2008, PN Diament Sp. z o.o.'s sales revenue amounted to PLN 209.2m, 58% of which accounted for sales to customers other than the PGNiG Group's companies. A consortium of PN Diament Sp. z o.o. and PNiG Jasło Sp. z o.o. conducted drilling work for KGHM Polska Miedź S.A. at 26 exploratory boreholes in areas covered with copper deposit licences. Furthermore, the company rendered general construction engineering services, mainly related to road and on-ground structures. For the PGNiG Group the company conducted boreholes drilling work, carried out repairs and liquidations of boreholes, and provided a range of specialist services, including operational borehole production intensification and repair, cementing boreholes and work related to drilling fluids.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	209.2	161.3
Net profit (loss)	PLNm	6.8	8.8
Equity	PLNm	92.2	91.7
Total assets	PLNm	134.0	132.9
Headcount as at December 31st	person	675	613

In 2009, as part of consortium with PNiG Jasło Sp. z o.o., PN Diament Sp. z o.o. will continue drilling work for KGHM Polska Miedź S.A. at six exploration boreholes. The company will also provide services related to general construction engineering for customers other than the PGNiG Group's companies, borehole drilling, repairs and liquidation of boreholes as well as other specialist services for the PGNiG Group.

ZRG Krosno Sp. z o.o.

Zakład Robót Górniczych Krosno Sp. z o.o. is a specialist borehole mining service company. Its business activity comprises in particular work in producing boreholes, including repair and reconstruction of oil and gas production boreholes, shallow drilling (up to approx. 1,000 meters), production borehole recompletion, and liquidation of boreholes, infrastructure and drilling pits, as well as other liquidation of other effects of borehole mining. In addition, the company provides a wide range of production intensification, measurement and laboratory services.

In 2008, ZRG Krosno Sp. z o.o. posted total sales revenue of PLN 79.1m, 84% of which accounted for sales to the PGNiG Group. Other customers include domestic borehole mining companies engaged in exploration of mineral reserves and geothermal water. In Poland, ZRG Krosno Sp. z o.o. provided services at producing boreholes, chiefly related to repairs, reconstruction and liquidation. ZRG Krosno Sp. z o.o. also provided borehole mining services on the international markets in Kazakhstan, Mozambique (for PNiG Kraków Sp. z o.o.), Ukraine, Slovakia and Latvia.

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Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	79.1	88.6
Net profit (loss)	PLNm	3.9	3.9
Equity	PLNm	41.3	39.2
Total assets	PLNm	59.5	62.0
Headcount as at December 31st	person	436	427

PGNiG S.A. will remain the company's key partner in the coming years. In addition, ZGR Krosno Sp. z o.o. plans to diversify into other markets in Central and Eastern Europe. In 2009, the company will continue its work at boreholes for customers in Poland, in particular work related to repair, reconstruction and liquidation of boreholes, and will also conduct production intensification work in Kazakhstan and Ukraine.

PGNiG Norway AS

PGNiG Norway AS was established to implement the project in the Norwegian Continental Shelf, which is aimed at increasing the volume of oil and gas reserves held outside of Poland. The Company holds a 15% interest in three licences (PL 212, PL 212B and PL 262) covering the Skarv and Snadd fields. The remaining interests are held by British Petroleum, as the operator – (30%), StatoilHydro (30%) and E.ON Ruhrgas Norge (25%). PGNiG Norway AS's core business comprises exploration and production of crude oil and natural gas reserves in the Norwegian Continental Shelf and participation in infrastructural projects related to crude oil and natural gas transmission activities.

Reserves are developed by British Petroleum and PGNiG Norway AS, StatoilHydro and E.ON Ruhrgas. As a result of combining the Skarv and Snadd fields with the Idun field in the Norwegian Continental Shelf, the companies' approximate shares in the exploration and production area are as follows:

- British Petroleum (the operator) 24%
- StatoilHydro 36%
- E.ON Ruhrgas Norge 28%
- PGNiG Norway AS 12%.

In 2008, the Skarv project entered into the reserve development stage. Production is expected to commence in 2011. Under the development project, 16 boreholes will be drilled, including seven oil extraction boreholes, five natural gas extraction boreholes and four injectors. At a later stage of the reserve life, the injectors will be transformed into gas producers in order to fully exploit the reserve potential. Drilling equipment will be mobilised at the end of 2009.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	0	0
Net profit (loss)	PLNm	-41.8	-7.2
Equity	PLNm	162.8	217.5
Total assets	PLNm	1,412.3	1,075.4
Headcount as at December 31st	person	19	10

On January 1st 2009, under an agreement with StatoilHydro Petroleum AS, PGNiG Norway AS acquired, free of charge, 30% of interest in PL 350 license in the Norwegian Continental Shelf. Once it receives an approval of the Norwegian Ministry of Petroleum and Energy and the Norwegian Ministry of Finance, PGNiG Norway AS will acquire a 25% interest in PL 419 license for a token amount of NOK 1.0 under an agreement with Nexen Exploration Norge AS.

POGC-Libya B.V.

On February 4th 2008, PGNiG Finance B.V. was transformed into Polish Oil and Gas Company-Libya B.V. to carry out exploration under the license No. 113 located in the Murzuq petroleum basin (western Libya). The company was issued a warranty by PGNiG S.A. securing its performance of the licence obligations. On February 25th 2008, POGC-Libya B.V. signed the Exploration and Production Sharing Agreement (EPSA) with state-owned Libyan oil company National Oil Corporation, which was ratified on June 1st 2008. In H1 2009, the acquisition of field data commenced.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	0	0
Net profit (loss)	PLNm	-8.1	-1.4
Equity	PLNm	-6.3	2.8
Total assets	PLNm	56.4	2.8
Headcount as at December 31st	person	13	-

5. Risks Related to Exploration and Production

Resource Discoveries and Estimates

The main risk inherent in exploration activity is the risk of no reserve discovery, i.e. the exploratory risk. This means that not all the identified potential reserve sites have sufficient deposits of hydrocarbons meeting the definition of the reserve. Whether or not such deposits exist depends on a number of geological factors. Furthermore, the actual quantity and quality of the accumulated hydrocarbons may differ from expected. When the results of successful exploration activity, in the form of documented new reserves, do not offset the production from the existing deposits, PGNiG S.A. documented producible reserves will decrease pro rata to the current production volumes.

A number of the factors and assumptions adopted when determining the extent of resources and production projections may turn out erroneous due to flaws in the methods and measurement equipment used in the geophysical surveys, drilling and production testing. Data on economically viable producible reserves of crude oil and natural gas is actually estimated and the 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 the full business cycle from the commencement of exploration to the launch of production from a developed field lasts six to eight years, while the hydrocarbon production cycle lasts from 10 to 40 years. Deposit parameters established in the course of preparing the relevant documentation are reviewed upon deposit development. Each downgrade of the extent of the resources or extraction figures may lead to a lower revenue and adversely impact PGNiG S.A.'s financial performance.

Competition

Both on the Polish market and abroad there is a risk of competition from other companies with respect to acquisition of licences for exploration and prospecting of deposits i.e. implementation of a strategy providing for acquiring access to own hydrocarbon resources. Certain competitors of PGNiG S.A., especially those active globally, enjoy strong market positions and have financial resources larger than those of PGNiG S.A. Thus it is probable that such companies would submit their bids in tender offers and be able to acquire promising licences. Competitors are also able to define, value, offer and purchase numbers of fields (including the operation thereof and underlying licences) larger than it would be possible in the case of PGNiG S.A., given the Company's financial and human resources. This competitive edge of other market players is particularly important on the international market. However, in view of the growing intensity of the global financial crisis, the risk seems to be decreasing.

Delayed Work

Under the currently binding Polish legal regulations, obtaining a licence for exploration and prospecting of crude oil and natural gas deposits lasts from one to one and a half year. As regards business activity on foreign markets, it 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 obliged to arrange for numerous formalities, 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 for a work contractor. Under the currently binding legal regulations, another several months pass before an agreement with the work contractor is signed. In addition, companies must frequently wait for a very long time before their imported equipment receives customs clearance. These factors create the risk of delayed exploratory work.

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

- local governments' failure to adopt local land development plans (MPZPs)
- obstacles in incorporating projects into the MPZPs
- need to obtain and comply with administrative or other formal and legal decisions, including environmental decisions
- amendments to the current planning and development concept
- obstacles in obtaining permission from land owners to enter the site.

These factors significantly delay implementation of projects and commencement of on-site construction work. Concurrently, PGNiG S.A.'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 project. A protracted investment process exacerbates the risk related to estimation of capital expenditure.

Cost of Exploratory Work

Exploratory work is capital consuming, given the prices of energy carriers and materials. Cost of exploratory work is especially sensitive to steel prices, which are passed on 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. Profitability of foreign exploratory projects will to a significant extent depend on the movements in prices of oil derivative products and in exchange rates.

Legal Regulations Concerning Safety, Environmental Protection and Health

Ensuring compliance with environmental law in Poland and abroad might significantly increase PGNiG S.A.'s costs of operations. Currently, PGNiG S.A. incurs significant capital expenditure and

costs on harmonising its operations with ever more complex and stringent legal regulations concerning safety and health at work, as well as environmental protection. Act of May 18th 2005 amending the Natural Environment Protection Law and certain other acts (Dz.U. No. 113, item 954 of June 27th 2005) rendered the regulations governing the execution of projects which might affect the Nature 2000 sites more stringent and enhanced the environmental protection-related requirements in the scope of 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 clear also in other countries where PGNiG S.A. conducts exploratory activity.

Qualified Personnel

The presence of foreign companies on the Polish market intensified the companies' takeover of highly qualified employees with vast professional experience. This risk is especially high with respect to professionals specialised in the exploration of natural gas and crude oil deposits. In countries where PGNiG S.A. operates highly qualified staff is difficult to recruit.

Unpredictable Events

Hydrocarbon reserves developed by PGNiG S.A. are usually located at great depth, which is accompanied by extremely high pressures, and many of them include hydrogen sulphide in its chemical composition. Consequently, there exists a high degree of risk of an explosion, eruption or hydrocarbon leakage, which in turn may pose a threat to people (workers and local inhabitants), natural environment and also production equipment.

Changes in Legal Regulations

The legal regulations in some countries change frequently and unexpectedly, causing problems to entities conducting exploratory activity. This may be a particular threat in countries where law changes depend on the decisions of authoritarian governments.

Political and Economic Situation

Some countries where PGNiG S.A. carries out exploratory activity face the risk of armed conflicts or terrorist attacks, which may result in limitation, suspension or discontinuation of the exploration and production business there.

In some areas of PGNiG S.A.'s operations there is a risk of social and political destabilisation. Changes of governments may bring to a halt the processes of state administration issuing permits to conduct business activity related to oil. Additionally, these countries are at risk of internal conflicts and social unrest caused by poor social and demographic conditions in which the inhabitants of these countries live. The risks specified above may lead to limitation, suspension or discontinuation of the Company's operations.

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

In connection with the ongoing global economic crisis, there is considerable uncertainty as to investors' behaviour regarding demand for exploration work in the coming years. Exploration companies operating abroad are exposed to the risk of losing some markets and reducing the scope of activities outside of the country. Furthermore, foreign exchange fluctuations have a bearing on net results of companies because a sizeable portion of their revenue is generated in foreign currencies.

Chapter IV: Exploration and Production

The segment sells natural gas imported from other countries and produced from domestic deposits. Imported natural gas is purchased chiefly from eastern markets. The sale of natural gas through the distribution and transmission network is regulated by the Polish Energy Law, while gas prices are determined based on the tariffs approved by the President of the Polish Energy Regulatory Authority (URE). For the segment's purposes, three underground gas storage facilities are used: in Mogilno, Wierzchowice and Husów.

1. Purchases

In 2008, the PGNiG Group derived natural gas from imports and, to a limited extent, from domestic suppliers.

PGNiG S.A. imported natural gas mainly under the agreements and contracts specified below, i.e. the long-term contracts for imports from OOO Gazprom Eksport and VNG-Verbundnetz Gas AG, as well as medium-term contracts for supplies from ROSUKRENERGO AG and VNG-Verbundnetz GAS AG/ E.ON Ruhrgas AG:

- Contract for sales of Russian natural gas to the Republic of Poland, executed with OOO "Gazprom Eksport", dated September 25th 1996, which will remain in force until 2022;
- Agreement on sales of the Lasów natural gas executed with VNG-Verbundnetz GAS AG, dated August 17th 2006, which will remain in force until October 1st 2016;
- Agreement on sales of natural gas executed with VNG-Verbundnetz GAS AG/E.ON Ruhrgas AG, dated September 15th 2004, which will remain in force until September 30th 2008;
- Agreement on sales of natural gas executed with ROSUKRENERGO AG, dated November 17th 2006, which will remain in force until January 1st 2010 and may be extended until January 1st 2012;
- Agreements on sales of the Lasów 2008 natural gas executed with VNG-Verbundnetz GAS AG, dated September 29th 2008, remaining in force from October 1st 2008 until October 1st 2011.

In connection with the expiry on September 30th 2008 of the agreement on gas sales executed with VNG-Verbundnetz Gas AG/ E.ON Ruhrgas AG and the change in the volume of gas supplied by VNG-Verbundnetz Gas AG, on September 29th 2008, PGNiG S.A. and VNG-Verbundnetz Gas AG executed the agreement on sales of the Lasów 2008 natural gas. Under the agreement, the Company will purchase 500 million m³ of natural gas annually.

The table below sets forth the structure of natural gas supplies measured as high-methane gas equivalent.

Structure of natural gas supplies (million m³)

	2008	%	2007	%
Imports, including:	10,264.3	99.8%	9,286.0	99.9%
- OOO Gazprom eksport	7,056.7	68.7%	6,219.2	67.0%
- ROSUKRENERGO AG	2,377.2	23.2%	2,279.3	24.5%
- Other foreign suppliers	830.4	8.1%	787.5	8.5%
Domestic suppliers	22.1	0.2%	15.8	0.1%
Total	10,286.4	100.0%	9,301.8	100.0%

In the early weeks of 2009, supplies of gas from the eastern markets were disrupted as a result of the conflict between Russia and Ukraine. Furthermore, gas supplies from ROSUKRENERGO AG have been suspended since January 2009, although the relevant agreement remains in force until January 1st 2010. As a result of reducing and then finally discontinuing gas supplies delivered through the Drozdovitse cross-border point, gas supply routes were changed and more gas has been delivered through the Vysokoye cross-border point. Gas supplies delivered through Drozdovitse were resumed, but gas volumes are lower, as a result of the failure of deliveries under the ROSUKRENERGO AG agreement. In order to secure a sufficient level of gas supplies to its customers, PGNiG S.A. increased the use of gas held in storage facilities. Following discussion with OOO Gazprom eksport, the Company secured a temporary increase in the volume of gas collected under the effective agreement.

LNG Terminal

As part of its strategy to diversify natural gas supplies, PGNiG S.A. is involved in a project consisting in importing liquefied natural gas to Poland. In 2008, Polskie LNG Sp. z o.o., a PGNiG S.A. subsidiary, conducted work on the construction design of the LNG terminal and efforts aimed at obtaining the required building permits were in progress. On January 10th 2008, an agreement was signed with SNC Lavalin Services Ltd. for the preparation of technical and economic documentation of the LNG terminal, together with the necessary permits.

Pursuant to the resolution of the Council of Ministers of August 19th 2008 concerning efforts aiming at diversification of natural gas supplies to Poland, on December 8th 2008, PGNiG S.A. sold 100% shares in Polskie LNG Sp. z o.o. to OGP GAZ-SYSTEM S.A. The transaction was valued at PLN 52m.

2. Sales

In 2008, PGNiG S.A. signed comprehensive agreements for supply of gaseous fuel, from both transmission and distribution systems, to 92.9 thousand new customers, including 91 thousand households.

Pursuant to the provisions of the Polish Energy law, in 2008 PGNiG S.A. commenced replacement of commercial agreements with comprehensive agreements. The process is expected to be completed by December 31st 2009.

The key products sold by this segment are high-methane natural gas and nitrogen-rich gas. In 2008, sales of natural gas (high-methane equivalent) grew by approx. 1.1% (or 144.3 million m³) year on year. The PGNiG Group sold gas both in Poland and on international markets. The structure of 2008 sales by the Trade and Storage segment is presented in the table below:

Sales structure of key products

	Unit	2008	2007
1	Natural gas, including:		
	- high-methane gas	million m ³	13,119.1
	- nitrogen-rich gas*	million m ³	12,974.8
		million m ³	12,313.8
		million m ³	805.3
2	Propane-butane	thousand tonnes	2.0
			2.1

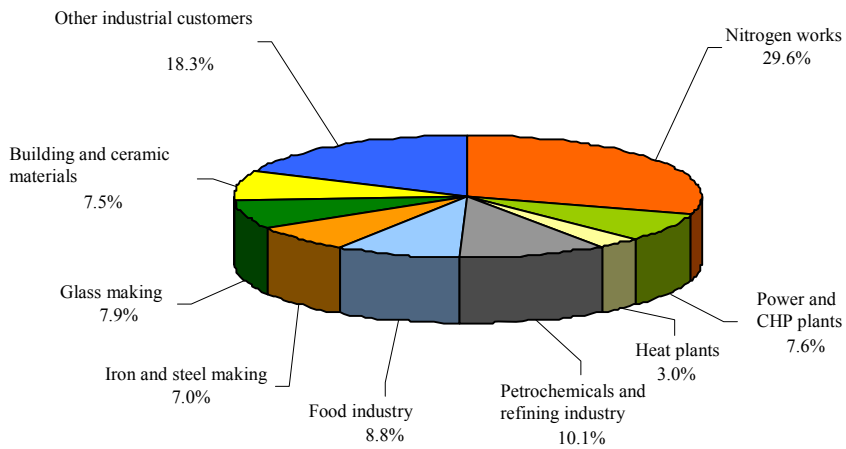
* million m³ measured as high-methane gas equivalent

The Group's main customers who purchased natural gas included chemicals sector, the steel industry and the power sector, as well as households. Households make up the largest group of customers purchasing natural gas, accounting for 97% of the entire customer base (approx. 6.4m). Their share in the sales volume is 28%. The most prominent share in the natural gas sales was claimed by industrial customers (61%). The table below presents the structure of natural gas sales measured as high-methane gas equivalent broken down by major customers.

Sales of natural gas supplied via the transmission system (million m³)

	2008	%	2007	%
Industrial customers	7,933.6	60.5%	7,848.6	60.5%
Trade and services	1,390.0	10.6%	1,326.3	10.2%
Households	3,622.4	27.6%	3,640.9	28.1%
Wholesale customers	136.5	1.0%	119.2	0.9%
Exports	36.6	0.3%	39.8	0.3%
Total	13,119.1	100.0%	12,974.8	100.0%

Structure of sales of natural gas to industrial customers in 2008



3. Storage

The Trade and Storage segment uses a part of the capacities of underground storage facilities for its own purposes. Short-term fluctuations in the demand for natural gas are balanced out with the supplies from the Underground Gas Storage Cavern Facility Mogilno located in worked-out salt caverns, which is operating at full capacity. The capacities of the Underground Storage Facility Wierzchowice and the Underground Storage Facility Husów are used to minimise the effect of an uneven demand for natural gas in 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 Underground Storage Facility Wierzchowice, Underground Storage Facility Husów and the Underground Gas Storage Cavern Facility Mogilno help the Group comply

with the 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 a Threat to National Fuel Security or a Disruption on the Petroleum Market, dated February 16th 2007.

In 2008, PGNiG S.A. continued efforts to expand available capacity of the existing Underground Gas Storage Facility in Wierzchowice and the Underground Gas Storage Cavern Facility in Mogilno (storing high-methane gas), and to prepare the construction of a new high-methane gas storage facility at the Kosakowo Underground Gas Storage Cavern Facility. Available capacities of the storage facilities as at the end of 2008 are presented in the table below.

Available capacities of storage facilities in the Trade and Storage segment

	million m ³
Husów	400.0
Mogilno	380.2
Wierzchowice	575.0

4. Activities Planned in the Trade and Storage Segment

The Baltic Pipe Project

The objective of the project is to create a direct pipeline for the supply of natural gas from Denmark to Poland and also, in future, from Poland to Denmark. In 2008, pursuant to a cooperation agreement executed by PGNiG S.A., OGP GAZ-SYSTEM S.A. and Energinet.dk on November 15th 2007, the parties jointly conducted technical analyses and worked on the detailed arrangements relating to the execution of the Baltic Pipe project.

On December 16th 2008, PGNiG S.A. and OGP GAZ-SYSTEM S.A. executed Agreement on Acquisition of Documentation and Termination of Cooperation Agreement regarding the Baltic Pipe Project. On January 29th 2009, the Extraordinary General Shareholders Meeting of PGNiG S.A. decided to sell the documentation related to the implementation of the Baltic Pipe project to OGP GAZ-SYSTEM S.A. According to current plans, OGP GAZ-SYSTEM S.A. is to take responsibility for the execution of the project going forward.

In 2009, PGNiG S.A. and OGP GAZ-SYSTEM S.A. will jointly undertake geophysical studies of the seabed on specified alternative versions of the Baltic Pipe routes, with a view to selecting the optimum course.

The Skanled Project

In 2007, PGNiG S.A. joined the consortium established for the purpose of construction of the Skanled gas pipeline which is designed to connect a gas terminal on the Norwegian Continental Shelf with Sweden and Denmark. PGNiG S.A. acquired a 15% stake in the project and became one of its 15 shareholders. The investment is executed by Gassco, a Norwegian operator of off-shore gas pipelines. In January 2008, the Skanled Consortium approved the technical changes in the design, consisting primarily in the increase of the pipeline diameter in order to raise its throughput. On April 17th 2008, the members of the Consortium resolved to commence the pre-design stage of the project and concurrently approved the changes to the technical concept of the network proposed by Gassco, which increased the estimated cost of the project. The investment decision is planned to be made in October 2009. According to the project schedule, the Skanled gas pipeline is to be placed in operation in 2013.

In November 2008, Hafslund Varme & Infrastructure, holder of a 10% interest in the Skanled consortium, withdrew from the consortium. As a result of negotiations with external investors, it was agreed that VNG-Verbundnetz Gas AG would join the consortium. It was also decided that the new consortium member would acquire the 10% interest in the consortium and reserve capacity on the Skanled gas pipeline. The composition of the Skanled Consortium again changed in February 2009 when the state-owned Norwegian company Petoro AS joined the consortium. It acquired the interests of Ostfold Energi and Agder Energi, which withdrew from the consortium, and a part of the interest held by Skagerak Energi. In total, Petoro AS acquired a 25% interest in the project, thus becoming the largest shareholder in the Skanled Consortium.

Concurrently, PGNiG S.A. is working on the transfer of its stake in the Skanled Project to its Norwegian subsidiary, PGNiG Norway AS.

The Boernicke-Police Interconnection

Trade with the German market is the rationale for constructing the Boernicke-Police interconnection linking Poland and Germany. In October 2008, PGNiG S.A. launched the construction of a 14-kilometers gas pipeline Tanowo-Dobieszczyn.

Natural Gas Purchase

As a result of failure of gas deliveries under the ROSUKRENERGO AG contract, PGNiG S.A. is taking action to obtain gas from alternative sources. Therefore, the existing structure of gas imports may change. Furthermore, in 2009 the Company will seek to ensure LNG supplies and execute a long-term supply contract.

Natural Gas Sales

The projected rise in the natural gas sales volume is attributable to development investments of PGNiG S.A.'s strategic customers in the petrochemical, construction and steel sectors. In 2008, PGNiG S.A. continued cooperation, started in 2007, concerning possible gaseous fuel supplies with several major prospective customers, including companies operating in the power sector and planning to replace hard coal fired generating units with gas fired ones. Supplies of natural gas for the needs of the upgraded power/CHP plants are planned to commence in 2012-2013.

Underground Gas Storage Facilities

On November 19th 2008, PGNiG S.A. and consortium comprising PBG S.A. Przeźmierowo, Tecnimont S.p.A. (Italy), Societe Francaise d'Etudes et de Realisations d'Equipements Gaziers SOFREGAZ (France), Plynostav Pardubice Holding A.S. (the Czech Republic), and Plynostav – Regulace Plynu A.S. (the Czech Republic) executed an agreement on the project designated as the Construction of the Surface Section of the Wierzchowice Underground Gas Storage Facility, Phase: 3.5 billion nm³, Subphase: 1.2 billion nm³. The agreement's value is approx. PLN 1.1bn. In 2009, PGNiG S.A. will commence drilling and construction of the surface section of the Wierzchowice Underground Gas Storage Facility. Additionally, other plans provide for drilling and construction of a leaching plant at the Kosakowo Underground Gas Storage Facility and further development of the Mogilno Underground Gas Storage Cavern Facility.

5. INVESTGAS S.A.

INVESTGAS S.A. specialises in the execution of projects in the area of hydrocarbon storage and transport. It also executes specialist and general construction projects. The company provides services covering the entire investment process, from the preparation, to design, construction, technological start-up and operation of storage facilities in salt caverns and other facilities.

In 2008, the company's sales revenue totalled PLN 65.5m. Revenue from sales of services to PGNiG S.A. represented 92% of total sales revenue. The services performed for PGNiG S.A. included:

- operation and extension of the Underground Gas Storage Cavern in Mogilno
- preparation for the construction of the Underground Gas Storage Facility in Kosakowo
- preparation for the construction and supervision over the construction of the KGZ Kościan-KGHM Polkowice/Żukowice gas pipeline.

In addition, the company also performed other tasks, including preparatory work and supervision over the construction of the Ostrów Wielkopolski-Wrocław fuel pipeline for PKN ORLEN S.A. and preparatory work preceding implementation of the Baltic Pipe project.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	65.5	33.9
Net profit/loss	PLNm	4.0	2.6
Equity	PLNm	13.1	10.5
Total assets	PLNm	30.6	24.9
Headcount as at December 31st	person	91	86

In 2009, the services provided by the company will include further development of work regarding operation, construction and extension of the underground gas storage facilities, work related to the construction of the KGZ Kościan – KGHM Polkowice/Żukowice gas pipeline and preparatory work preceding execution of the next phase of the Ostrów Wielkopolski-Wrocław fuel pipeline construction for PKN ORLEN S.A. and supervision over the construction process. The company also plans to increase the value of its sales by winning new, large fuel contracts for such investors as PKN ORLEN, LOTOS and PERN.

6. Trade- and Storage-Related Risks

High Natural Gas Prices

The major risk factor posing a threat to gas market growth is the price of natural gas, which is high relative to the price of alternative energy sources, especially coal. This situation is a serious impediment to the growth of gas power business. As a result of the change to the PGNiG S.A. tariff and the economic slowdown in Poland, industrial customers scale down their production activities and reduce investments, which, to a large extent, affects the volume of gas sold by PGNiG S.A. Furthermore, given the rising prices of gas, some customers actively seek alternative energy sources.

Competition

At present, PGNiG S.A. is the largest supplier of natural gas in Poland. PGNiG S.A.'s share in the gas market is approx. 98%, the remaining 2% is represented by suppliers from outside the PGNiG Group which usually purchase gas from PGNiG S.A. Suppliers from outside the PGNiG Group which trade

in natural gas operate mostly in the areas which have not been covered by the gas pipeline networks. Some of the aforementioned companies own a transmission infrastructure. Recently, new entities are becoming increasingly active on the Polish market. These entities are local gas distributors which offer innovative solutions of the natural gas supply involving the use of LNG. An intensified commercial activity of competitors which aims at attracting current and potential customers of the PGNiG Group may pose in future a tangible threat of customer churn.

Reduced Volume of Gaseous Fuel Sales

Due to the slower pace of economic growth, rising unemployment and deterioration in the financial standing of customers, there is a risk that sales of gaseous fuels may decline. Furthermore, lower sales may also result from reduced supplies of imported gas.

Gas Supplies

At the beginning of 2009 the deliveries of natural gas from the eastern markets were again disrupted as a result of a conflict between Russia and Ukraine. In addition, gas supplies under the ROSUKRENERGO AG contract have been suspended since early 2009. In Q1 2009, the demand for natural gas was wholly satisfied by temporarily increasing the volumes of gas supplied by OOO Gazprom eksport and expanding the use of gas from underground storage facilities. With a view to compensating for the lost volumes of gas under the ROSUKRENERGO AG contract, PGNiG S.A. works towards securing gas from alternative sources. Taking into consideration the policy pursued by the key supplier and the political and economic environment in the transit countries, disruptions in gas supplies are likely to reoccur in future.

LNG Terminal

Meeting the deadline for the terminal construction is important. If the projected date of the first deliveries and the completion of the project are not concurrent, the party ordering natural gas, i.e. PGNiG S.A., may have to incur additional costs.

Skanded Project

The construction of the Skanded Pipeline is conditional upon numerous factors, including principally the execution, by all Consortium members, of gas purchase agreements providing for sufficient quantities of natural gas. Furthermore, the execution of the Skanded Project in line with the timetable requires timely obtainment of necessary administrative permits. Moreover, PGNiG S.A.'s participation in the Project depends upon the final decision concerning implementation of the Baltic Pipe Project and PGNiG S.A. obtaining the required flow capacity in the Danish transmission system.

Storage

Since the provisions of the Act on Stocks of Crude Oil, Petroleum Products and Natural Gas require the Company to increase mandatory stocks of gas, in the coming years PGNiG S.A. may be exposed to the risk of shortages of available capacity, output capacity and gas compression capacity. As a result, working output and available capacity used to meet PGNiG S.A.'s commercial needs may be insufficient during winter time. This situation may be further aggravated if the President of the Polish Energy Regulatory Authority refuses PGNiG S.A.'s request for temporary exemption from the obligation of gaseous fuels storage, and, additionally, if mandatory stocks are not excluded from the storage facility definition. If storage facilities are lent for use to third parties, there is a potential risk of insufficient capacity and output to secure a sufficient level of mandatory stocks, as required under the Act on Stocks of Crude Oil, Petroleum Products and Natural Gas.

Another risk factor is a possibility of a deficit of funding required for the planned capex. If the European Commission refuses to co-finance projects at the Mogilno Underground Gas Storage Cavern Facility, the Kosakowo Underground Gas Storage Cavern Facility, the Strachocina Underground Gas Storage Facility and the Wierzchowice Underground Gas Storage Facility, PGNiG S.A. will be required to seek additional funding in the amounts requested for the relevant projects (i.e. approx. PLN 410m, as specified in the List of Individual Projects for the Purposes of the Operational Programme Designated as Infrastructure and Environment 2007-2013).

Chapter V: Distribution

The segment's core activity consists in the transmission of high-methane and nitrogen-rich gas, as well as small amounts of propane/butane and coke-oven gas, via the distribution network. Distribution of natural gas is handled by six Gas Companies, which supply gas to households, industrial customers and wholesalers. Additionally, they are responsible for operating, overhauling and extending the distribution network. Based on a decision of the President of the Energy Regulatory Authority, the Gas Companies have been granted the status of Distribution System Operators.

The geographic footprint of the Gas Companies is shown on the map below.



1. Dolnośląska Spółka Gazownictwa

Dolnośląska Spółka Gazownictwa Sp. z o.o. supplies gas to customers in the Provinces of Wrocław, and Zielona-Góra, and in the Wolsztyn county (Province of Poznań). The percentage of households and businesses connected to the gas grid varies between communes, depending on geographical conditions. Areas without access to the gas-supply system are usually those located at a considerable distance from the pipelines, in whose case the relevant studies have shown that their connection to the gas grid would not be economically viable. In such areas, for instance in the area around the village of Świątoszów, the company provides customers with gas in liquefied form (LNG).

The total volume of gas transmitted by DSG Sp. z o.o. via the distribution network in 2008 was 997.8 million m³, of which high-methane gas, nitrogen-rich gas (Lw) and nitrogen-rich gas (Ls) accounted, respectively, for approx. 68%, 31.7% and approx. 0.3%. The company has some 745.4 thousand customers. In 2008, DSG Sp. z o.o. connected to the gas network 6.3 thousand new customers. The annual consumption of gas by the new customers is expected to reach approx. 61 million m³.

In 2008, the company continued to replace the cast-iron piping whose further operation would have posed a safety hazard and resulted in huge gas loss. The implementation of the cast-iron piping replacement programme, as well as regular technical inspections of the network, have resulted in a drop in the share of gas loss in relation to sales.

Other work carried out by DSG Sp. z o.o. in 2008 included the extension and modernisation of the gas network. The major projects completed in 2008 included:

- modernisation of the leaky pipeline from Zakęcie to Nowa Sól, aimed to improve security of gas supplies
- extension of the gas grid in the town of Żary, aimed to improve security of gas supplies to Żary, and construction of the first grade station within the Kronopol station.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	339.6	711.3
Net profit	PLNm	40.8	-165.9
Equity	PLNm	944.5	795.0
Total assets	PLNm	1,142.8	1,055.8
Length of network, excl. connections*	km	7,636.8	7,053.3
Headcount as at December 31st	person	1,390	1,319

* Company's own and third-party networks

In the years to come, DSG Sp. z o.o. is going to focus on maintaining its current market position, while further increasing gas throughput by:

- expanding its gas infrastructure to enable connection of new customers
- replacing cast-iron piping and upgrading medium- and low-pressure networks
- transporting gas in liquefied form and providing customers with access to gas supply by means of LNG units.

In the area where DSG Sp. z o.o. operates, a number of other gas sellers and distributors are intensifying their activities. In future, they may take over the company's existing or prospective customers (both industrial and individual ones). In the area covered by DSG Sp. z o.o.'s operations, there are two key competitors: Media Odra Warta Sp. z o.o. (MOW) and G.EN. GAZ ENERGIA S.A.

2. Górnośląska Spółka Gazownictwa Sp. z o.o.

Górnośląska Spółka Gazownictwa Sp. z o.o. supplies gas to customers in the Provinces of Katowice and Opole, in 44 communes of the Province of Kraków, in 5 communes of the Province of Łódź and in 3 communes of the Province of Kielce. It serves some 1.3 million customers. The total volume of gas transmitted by GSG Sp. z o.o. via the distribution network in 2008 was 1,371.2 million m³.

In 2008, GSG Sp. z o.o. connected to the gas network 4.4 thousand new customers. The annual consumption of gas by the new customers is expected to reach approx. 260.1 million m³. In addition, the company carried out work on the network modernisation, while continuing to connect to the gas

grid households and businesses located west of Częstochowa. The major projects that were underway in 2008 included:

- reconstruction of the approx. 5-km long gas pipeline from Zdieszowice to Blachownia
- modernisation of the approx. 20-km long gas pipeline from Zdieszowice to Tworzeń (including modernisation of a 15-km stretch with the use of the Compact Pipe technology)
- connection of the village of Komprachcice to the gas-supply system; the project comprises construction of approx. 40km of medium-pressure gas pipelines
- connection of the commune of Dąbrowa to the gas-supply system; the project comprises construction of approx. 23 km of medium-pressure gas pipelines
- connection of the village of Herby and the town of Blachownia to the gas-supply system; the project comprises construction of approx. 35 km of high- and medium-pressure gas pipelines.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	518.2	1,126.9
Net profit	PLNm	19.5	19.2
Equity	PLNm	1,507.3	1,394.8
Total assets	PLNm	1,729.1	1,636.3
Length of network, excl. connections*	km	20,488.7	19,827.4
Headcount as at Dec 31	person	2,589	2,515

* Company's own and third-party networks

In 2009, the company is going to continue work on the connection to the gas grid of areas located west of Częstochowa and around the city of Opole. In Upper Silesia and the Province of Opole, new sites are being designated for development projects and new road connections are being built. What this means for the company is a larger potential market for its distribution services, as new industrial plants appear which in future may become the company's institutional customers.

In the area of GSG Sp. z o.o.'s operations, competitive gas distributors have been intensifying their presence. They are integrated companies, offering customers not only the construction of network connections, but also the supplies of gaseous fuel. The major ones are API Testo/KRI and CP ENERGIA S.A./K&K. A significant strength of the competitive gas distributors lies in their ability to provide temporary supplies of liquefied gas when the gas network is still under construction. Moreover, the existing and prospective gas users have recently intensified their efforts aimed at establishing direct connections with the network of OGP GAZ-SYSTEM S.A.

3. Karpacka Spółka Gazownictwa Sp. z o.o.

The area covered by the company's operations includes four provinces in south-eastern Poland, namely the Provinces of Kraków, Rzeszów, Kielce and Lublin. One of the main gas pipelines of the domestic transmission system runs through the company's operating area, fed with both imported and domestically-produced natural gas. The company serves some 1.4 million customers. The total volume of gas transmitted by KSG Sp. z o.o. via the distribution network in 2008 was 2,003.9 million m³.

In 2008, KSG Sp. z o.o. connected to the gas network 18.6 thousand new customers. The annual consumption of gas by the new customers is expected to reach approx. 201.7 million m³. In addition,

the company carried out work on the network extension and modernisation. The major projects that were underway in 2008 included:

- construction of an approx. 10.3-km long high-pressure gas pipeline to Zakład Przetwórstwa Wapienniczego Trzuskawica (a limestone processing plant)
- construction of an approx. 8.6-km long gas transmission pipeline from Werbkowice to Zamość
- construction of an approx. 7.9-km long medium-pressure gas grid in the town of Jędrzejów.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	681.3	1,561.5
Net profit	PLNm	67.3	-16.6
Equity	PLNm	2,189.2	1,947.8
Total assets	PLNm	2,577.7	2,405.9
Length of network, excl. connections*	km	43,927.7	42,820.4
Headcount as at December 31st	Person	3,306	3,265

* Company's own and third-party networks

The company plans to expand its distribution network by constructing traditional gas pipelines, as well as by developing the LNG market, on which KSG Sp. z o.o. will be responsible for liquefying and distributing the fuel. Distribution of LNG will support the initial provision of access to gas supply to those areas where the construction of traditional pipelines does not meet the necessary economic criteria. Once the local natural gas market is developed, distribution of LNG in such areas will enable the economically viable construction of traditional pipelines.

The company's other plans for the coming years include continued expansion of the distribution network in the Province of Kielce. Thanks to the flourishing minerals processing industry in the region, the company will be able to acquire new customers and achieve higher sales of distribution services.

In the area where KSG Sp. z o.o. operates, one can observe intensified activity on the part of companies aiming to build their own distribution networks in places which are not yet connected to the gas grid, as well as on the part of distributors of gas in liquefied form.

4. Mazowiecka Spółka Gazownictwa Sp. z o.o.

Mazowiecka Spółka Gazownictwa Sp. z o.o. supplies gas to customers in the Provinces of Warsaw, Łódź and Białystok, as well as in certain parts of the Provinces of Lublin, Olsztyn and Kielce (the aggregate area of approx. 87 thousand km²). The total volume of gas transmitted by MSG Sp. z o.o. via the distribution network in 2008 was 1,897 million m³. Gas is supplied to some 1.5 million customers via the gas network and gas stations operated by the company.

In 2008, the company conducted projects consisting in operating, extending and upgrading the gas network. MSG Sp. z o.o. connected 21.7 thousand new customers to the gas network. Major projects carried out in 2008 included:

- modernisation of an approx. 6.3-km long section of the gas grid from Białobrzegi to Grójec

- modernisation of an approx. 5-km long section of the gas grid, extending along Trakt Lubelski street in Warsaw
- construction of a gas grid section in Radomsko; providing gas supplies to the Łódź Special Economic Zone (streets: Sucharskiego, Pasieczna, Przemysłowa, Reja, Górnickiego, Witosa, Orzeszkowa and Narutowicza)
- construction of a connecting pipeline for Nova Ceramica in Mniszków
- construction of a connecting pipeline for Procter & Gamble in Aleksandrów Łódzki
- construction of a connecting pipeline for Indesit in Radomsko.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	659.2	1,413.8
Net profit	PLNm	91.9	-507.2
Equity	PLNm	1,793.9	1,381.1
Total assets	PLNm	2,224.2	1,803.0
Network length (excluding connections)*	km	18,361.0	16,634.0
Headcount as at December 31st	person	2,895	2,920

* Company's own and third-party networks

In 2009, MSG Sp. z o.o. intends to focus on:

- ensuring an adequate transmission capacity and securing sources of gas supply for the company's gas distribution system
- optimising the use of network assets held by the company by connecting new customers to the existing grid (network densification)
- extending the pipeline infrastructure for new customers
- improving the security of operating the company's network assets
- maintaining cooperation with PGNiG S.A. as part of a project which involves switching propane butane gas mixing/decompression plant into high-methane gas plant in the area covered by the Białystok Gas Plant.

5. Pomorska Spółka Gazownictwa Sp. z o.o.

PSG Sp. z o.o.'s geographical reach covers the Provinces of Gdańsk and Bydgoszcz, a part of the Province of Olsztyn, as well as two municipalities/communes of the Province of Szczecin (Sławno and Postomino). The area of the company's operations is characterised by a landscape that is difficult to manage when it comes to expanding the gas supply system (a large number of lakes and woods).

The total volume of gas transmitted by PSG Sp. z o.o. via the distribution network in 2008 was 881.9 million m³. The company has some 739.8 thousand customers. In 2008, PSG Sp. z o.o. connected to the gas network approx. 6 thousand new customers. The annual consumption of gas by the new customers is expected to reach approx. 54.5 million m³.

In 2008, the Company modernised the low-pressure and medium-pressure pipelines: it replaced a 9.5-km section of the emergency pipeline and a 3.8-km stretch of gas connections, and initiated further replacements with respect to a 2.3-km stretch of emergency pipeline and a 0.5-km segment of gas connections.

Major projects involving the extension of the gas network carried out in 2008 included:

- progress in the construction of the Bytów-Słupsk high-pressure pipeline and a first-grade pressure reduction and metering station; the primary objective of the extension is to improve security of gas supplies to Słupsk and its vicinity, as well as to enable connection of municipalities and communes located along the pipeline to the gas network; This project will ensure diversified gas supplies and connect the two gas systems supplying the Pomerania region: PSG Sp. z o.o. and the WSG Sp. z o.o.'s networks.
- construction of a high-pressure pipeline in Toruń, along with the first-grade pressure reduction and metering station, in order to improve security of gas supplies to the city of Toruń, industrial customers, Łysomice and Wielka Nieszawka communes and the Pomeranian Special Economic Zone
- incorporating into the gas supply system and placing in service of the high-pressure pipeline from Szubin to Kruszyn, along with the first-grade pressure reduction and metering station (whose construction was completed in 2007)
- incorporating into the gas supply system and placing in service of the high-pressure pipeline from Nidzica to Szczytno (whose construction was completed in 2007).

Moreover, on June 3rd 2008, an experimental CNG fuelling station was opened in Toruń under an agreement concluded between PSG Sp. z o.o., Toruń Municipality, Toruń Municipal Transportation Company, Biogaz Inwestor Sp. z o.o. and the Bydgoszcz Gas Company. The experimental nature of the project follows from the fact that the station is to ultimately use biogas as fuel for vehicles.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	345.9	736.7
Net profit	PLNm	21.2	-160.7
Equity	PLNm	805.7	672.5
Total assets	PLNm	1,189.0	1,017.7
Network length (excluding connections)*	km	9,014.2	8,125.4
Headcount as at December 31st	person	1,760	1,741

* Company's own and third-party networks

In the years to come, the company is going to carry on with its network-related projects by:

- constructing and modernising medium-pressure and low-pressure pipelines in the areas which are covered by the gas supply system
- constructing and modernising high-pressure pipelines to enable the supply of gas to areas which have not yet been covered by the gas supply system
- connecting new customers
- combining the pipelines into ring structures, thus improving the security of gas supplies.

The company's business – both in the areas which are covered by the gas supply system and those which have not yet been connected to the gas grid – is distinguished by a considerable growth potential, owing to the establishment of new and expansion of the existing special economic zones and industrial parks. The company evaluates the potential of individual communes and municipalities in order to assess whether projects involving gas system expansion are economically viable.

In the area of the company's operations, a number of new players entered the market for distribution and trade in gaseous fuels. These include G.EN. GAZ ENERGIA S.A., US.EN.EKO, KRI Sp. z o.o., ENERGO-EKO-INWEST Sp. z o.o., and P.L. Energia S.A.

6. Wielkopolska Spółka Gazownictwa Sp. z o.o.

WSG Sp. z o.o. manages a network of distribution pipelines covering an area of approx. 68.1 sq. km, including the Provinces of Poznań and Szczecin, several municipalities/communes in the Provinces of Łódź, Wrocław and Zielona Góra, as well as one municipality in the Province of Gdańsk. The percentage of households and businesses connected to the gas network within the area of WSG Sp. z o.o.'s operations is 44.4% (it is high in urban areas and towns, medium in mixed urban and rural areas, and low in typical rural areas).

The total volume of gas transmitted by WSG Sp. z o.o. via the distribution network in 2008 was 1,725.3 million m³, including 1,027.2 million m³ of high-methane gas. At the end of 2008, the total number of customers served by the company was 895.8 thousand. In 2008, WSG Sp. z o.o. connected to the gas network approx. 7 thousand new customers. The annual consumption of gas by the new customers is expected to reach approx. 124.5 million m³.

The major projects completed in 2008 included:

- construction of 337.54 km of high-, medium- and low-pressure pipelines, 8,342 gas connections and 89 gas stations, including one first grade reduction and metering station, of which the most significant projects were the construction of the Trzemeszno-Witkowo high-pressure pipeline and the construction of a gas network for Ostrów Wielkopolski (Zacharzew housing estate) and Radłów,
- purchase of 45.57 km of medium- and low-pressure pipelines and 348 gas connections, of which the most significant project was the purchase of the gas network in the Santok commune,
- modernisation of 21.65 km of medium- and low-pressure pipelines, 9.4 km of gas connections and six gas stations, of which the most significant projects were the modernisation of a housing community gas network in Poznań, conversion of first grade gas station and providing power supply for the Rumin commune.

In addition, in Q2 2008 Stage 1 of the process of switching the left-bank part of Poznań and the East Poznań Province from less caloric nitrogen-rich gas to high-caloric high-methane gas was launched. This process will improve the security and capacity of the distribution network. The switching process will be completed in 2009.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	515.8	1,116.6
Net profit	PLNm	39.0	-299.1
Equity	PLNm	1,409.0	1,184.0
Total assets	PLNm	1,727.0	1,520.7
Network length (excluding connections)*	km	14,572.1	13,431.5
Headcount as at December 31st	person	1,806	1,778

* Company's own and third-party networks

To maintain its current market position and to extend its distribution network, the company undertook actions aimed at delivering gas to the communes of Witkowo, Strzałkowo, Powidz, Włoszakowice, Lipno and Przemęt. In the next few years, the company will focus on:

- extension of the high-pressure distribution grid,

- cooperation with OGP GAZ-SYSTEM S.A. to determine planned projects related to the extension of distribution and transmission grids,
- cooperation with companies engaged in trade in gaseous fuels as part of projects to deliver gas to new areas.

In the company's area of operations there has been an increased activity in the business of distribution and trade in gaseous fuels by such operators as G.EN. GAZ ENERGIA S.A., Media Odra Warta Sp. z o.o., E.ON edis energia Sp. z o.o., CP Energia S.A., P.L. Energia S.A.

7. Risks Related to Distribution

Direct Competition

The liberalisation of the gas market is likely to boost the activity of gas suppliers who are the competitors of the PGNiG Group's Gas Companies. Over the last few years, the activity of those suppliers has been regular and steady. They have gradually developed their gas networks and acquired new customers, both among individuals and businesses. Another issue which poses a serious threat to the Gas Companies' business is the tariff policy of the URE, as it prevents the Gas Companies from operating a flexible pricing policy for their key customers. With the lack of flexible pricing, customers may find the offering of the competition very attractive.

Legislation

An important factor with a bearing on the Gas Companies' operations is the long time required for preparation of a project. The Construction Law and environmental protection regulations impose the obligation of preparing the documentation and obtaining numerous approvals and decisions in order to obtain a building permit.

Lower Volume of Transmitted Gaseous Fuel

The consequences of the ongoing global economic crisis for Poland include: an economic slowdown, lower scale of key projects or suspension of their execution, higher unemployment rate. There is a risk that the demand for natural gas and distribution services will decline in connection with deteriorating economic standing of manufacturing companies (as they will scale down or suspend their production activities).

Substitution

The easy and quick access to alternative energy sources (i.e. fuel oil, LPG, hard coal, electricity or heat generated by central CHPs, or local or community heat plants) may weaken the position of the Gas Companies on the local energy markets.

Chapter VI: Other Operations

The segment encompasses designing and building structures, plant and equipment for the mining sector and the fuel and energy sector, as well as offering services associated with the catering and hospitality industry. The said activities are conducted mainly by the Group members.

B.S.iP.G. "Gazoprojekt" S.A.

The core business of Biuro Studiów i Projektów Gazownictwa "Gazoprojekt" S.A. is comprehensive design of installations for gas production, storage, transfer and distribution, as well as gas system stations and switching stations. The company's majority shareholder is PGNiG S.A., holding 75% of its share capital. 25% of the shares are held by employees of B.S.iP.G. "Gazoprojekt" S.A.

In 2008, B.S.iP.G. "Gazoprojekt" S.A. generated sales revenue of PLN 34.9m, of which 48% represented services performed for the PGNiG Group. Apart from the PGNiG Group, the company's main customers were OGP GAZ-SYSTEM S.A., Przedsiębiorstwo Gospodarki Komunalnej "Dolina Baryczy" Sp. z o.o. and PKN ORLEN S.A. The projects for which the company performed designs and studies in 2008 included:

- Construction of a gas pipeline linking KGZ Kościan and KGHM Żukowice/Polkowice,
- Construction of a sewage system,
- Construction of the Goleniów compressor station,
- Extension and upgrade of the Storage Depot for PKN ORLEN S.A.

Company's highlights

	unit	2008	2007
Sales revenue	PLNm	34.9	23.6
Net profit/ loss	PLNm	1.6	1.0
Equity	PLNm	28.1	26.9
Total assets	PLNm	38.3	35.6
Headcount as at December 31st	person	222	196

When searching for new orders, B.S.iP.G. "Gazoprojekt" S.A. focuses on the domestic market and on the services for its strategic customers: PGNiG S.A. and OGP GAZ-SYSTEM S.A. The company's operations will remain focused on the design of gas transmission pipelines, gas distribution networks, underground gas storage facilities and gas infrastructure, such as compressor stations or switching nodes. The company plans to continue and extend the range of its design services relating to the oil sector, comprising production, storage, and transmission of crude oil and petroleum products. The company intends to expand its business to other segments of the Polish market, such as design services for construction of biomass-fired heat- or electricity-generating installations. The company also plans to provide services to foreign business partners.

BUG Gazobudowa Sp. z o.o.

The business of Budownictwo Urządzeń Gazowniczych Gazobudowa Sp. z o.o. comprises construction and overhauls of high- and medium-pressure gas pipelines, water pipes, oil pipes, as well as gas compressor stations and reduction and metering stations. The company provides services to customers in Poland and abroad.

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In 2008, BUG Gazobudowa Sp. o.o. generated total sales revenue of PLN 171.2m. Revenue from services performed for the PGNiG Group represented 63% of the company's sales revenue. Other large customers included OGP GAZ SYSTEM S.A. and HYDROBUDOWA Polska S.A.

In 2008, the company built 125.6 km of pipelines, including 119.5 km of gas transmission pipelines. During the year, it also carried out construction and assembly work, including the upgrade of switching nodes, the upgrade of KGZ Borzęcin (with in-deposit waste dumping capabilities), and the upgrade of water and sewage system in the Zabrze commune.

Company's highlights

	unit	2008	2007
Sales revenue	PLNm	171.2	141.4
Net profit/ loss	PLNm	1.1	0.0
Equity	PLNm	26.2	25.2
Total assets	PLNm	85.8	84.9
Headcount as at December 31st	person	604	552

Over the next few years, BUG Gazobudowa Sp. z o.o. plans to continue its operations in the same segments of the domestic and foreign markets, by engaging in the construction of transmission pipelines, upgrade of switching nodes, and construction of water and sewage systems as well as the accompanying infrastructure.

ZUN Naftomet Sp. z o.o.

The core business of Zakład Urządzeń Naftowych Naftomet Sp. z o.o. is the production and overhaul of equipment for oil and gas industry. The company operates in Poland and abroad.

In 2008, ZUN Naftomet Sp. z o.o. was engaged in production of pressure equipment used in surface development of boreholes, equipment and spare parts for oil platforms and drill ships, flame-proof transformer housings for coal mining as well as components and spare parts for construction equipment. The company also performed major repairs of high-pressure engines, and it repaired and produced components and parts for drilling equipment.

In 2008, the company generated total sales revenue of PLN 44.6m. In 2008, ZUN Naftomet Sp. z o.o. sold its products mainly to Polish and foreign customers from outside the PGNiG Group. Revenue from services performed for these customers accounted for 58% of the sales revenue.

Company's highlights

	Unit	2008	2007
Revenue from sales of products/ services, goods and materials	PLNm	44.6	39.1
Net profit (loss)	PLNm	2.5	2.3
Equity	PLNm	22.8	20.3
Total assets	PLNm	36.1	33.3
Headcount as at December 31st	person	500	472

Over the next few years, the company intends to consolidate its position on the domestic and foreign market, maintaining its existing product mix and the growing sales.

Geovita Sp. z o.o.

Geovita Sp. z o.o. provides hotel and catering services in 11 centres across the country, which form a network of recreation, training, conference and SPA facilities. They are located either at the sea coast, in the mountains areas or in the centre of Poland. The company offers its services to Polish and foreign customers.

In 2008, Geovita Sp. z o.o.'s sales revenue totalled PLN 28.9m. The company's main customers were from outside the PGNiG Group. Revenue from services performed for that group of customers accounted for 89% of the company's sales revenue.

Since 2007, Geovita Sp. z o.o. has been implementing its remedial plan for 2007–2010, under which it has commenced an investment programme to extend and modernise its centres, including those in Jadwisin, Wisła, Złockie, Łądek Zdrój and Dąbki. In 2008, the company completed the extension of the centre in Dąbki, which started in October 2007.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	28.9	26.4
Net profit (loss)	PLNm	-1.0	-1.7
Equity	PLNm	82.4	83.4
Total assets	PLNm	95.8	89.3
Headcount as at December 31st	person	277	286

Over the next few years, the company will continue with the implementation of the remedial plan launched in 2007, whose main objective is to restore profitability already in 2009. Furthermore, in the next few years the company plans to increase the number of customers, improve occupancy rates to 45%, and to roll out the uniform service standards across its entire network.

BN Naftomontaż Sp. z o.o.

Budownictwo Naftowe Naftomontaż Sp. z o.o. is engaged in delivery and construction of complete crude oil and gas mines. PGNiG S.A. holds an 88.83% interest in the company's share capital. Other shareholders are PBG S.A. of Wysogotowo (7.82% interest) and Control Process S.A. of Tarnów (3.35% interest).

In 2008, BN Naftomontaż Sp. z o.o.'s sales revenue totalled PLN 71.9m. Revenue from services performed for the PGNiG Group accounted for 88% of the company's sales revenue.

In 2008, the company conducted work related to the development of natural gas and crude oil reserves across the country, including in particular construction and overhauls of technical equipment for crude oil and natural gas mines as well as construction of technical installations of underground gas storage facilities. The company also conducted construction and installation work related to crude oil transport.

Since 2005, BN Naftomontaż Sp. z o.o. has been in composition proceedings with its customers following the decision of the District Court of Krosno, V Commercial Division, concerning a declaration of the company's bankruptcy with an agreement option. By virtue of a decision of the District Court of Krosno, V Commercial Division of July 26th 2005, the bankruptcy proceedings of BN Naftomontaż Sp. z o.o. were closed. As at the end of 2008, the company was ahead of its

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repayment schedules under the composition agreement. In 2008, the company repaid a total of PLN 2.2m in liabilities.

Company's highlights

	Unit	2008	2007
Sales revenue	PLNm	71.9	88.2
Net profit (loss)	PLNm	2.1	0.3
Equity	PLNm	12.5	10.4
Total assets	PLNm	45.8	48.4
Headcount as at December 31st	person	274	269

Over the next few years, the company plans to focus on its key domestic market for projects in the oil and mining industry and the transmission and distribution networks commissioned by PGNiG S.A. and foreign companies licensed to operate in Poland.

BN Naftomontaż Sp. z o.o. has an equity interest in NAFT-STAL Sp. z o.o. – the company holds 67.40% of shares in its share capital, with the remaining 32.6% held by natural persons. The core business of NAFT-STAL Sp. z o.o. comprises production of metal structure components and equipment for the mining and extraction industry, as well as production of building equipment.

Chapter VII: Investment Projects

In 2008, the PGNiG Group carried out a number of projects in all of its business areas. According to the financial statements, capital expenditure on property, plant and equipment and intangible assets incurred by the PGNiG Group in 2008 amounted to PLN 2,579.5m. The table below presents the expenditure structure by business segments.

Capital expenditure of the PGNiG Group in 2008

	PLNm
Exploration and Production	1,453.7
Trade and Storage	225.3
Distribution	879.4
Other	21.1
Total	2,579.5

1. Investment Projects in the Exploration and Production Segment

The expenditure on projects incurred in the Exploration and Production segment in 2008 amounted to PLN 1,453.7m. Below are described the major projects in the segment.

Exploration

In the area of exploration, capital expenditure totalled PLN 362.1m, including PLN 211.7m incurred mainly on positive boreholes and boreholes which were not completed. In 2008, eleven positive boreholes were drilled. The balance of PLN 150.4m was incurred on negative boreholes and was charged to costs of the financial year.

Lubiatów-Międzychód-Grotów Project

The objective of the project is to develop the Lubiatów-Międzychód-Grotów reserves of crude oil and natural gas and to facilitate transport, storage and sale of crude oil, natural gas, liquid sulphur and propane-butane mixture from the LMG Crude Oil and Natural Gas Mine. 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 to support collection and shipment of crude oil in rail tank cars and handle the pumping of crude oil collected from the LMG Crude Oil and Natural Gas Mine to the PERN Druzhba Pipeline,
- construction of a gas pipeline to the Denitrating Plant in Grodzisk to support the transmission of surplus gas from the LMG Mine to Grodzisk Denitrating Plant.

In 2008, the construction of the Dispatch Terminal was completed. The expenditure incurred in 2008 was PLN 26m. The total value of the project is estimated at approx. PLN 1.6bn.

The Grodzisk Project

The objective of this project is to support the sale of gas from nitrogen-rich reserves after the gas has been treated (cryogenic denitrating of nitrogen-rich gas) to the parameters of high-methane gas. The

Grodzisk Denitrating Plant is constructed with a view to increasing nitrogen-high gas production volume at the existing mines and from reserves earmarked for development.

The project provides for the development of the Wielichowo, Ruchocice and Paproć W reserves, connection of the Elzbieciny and Jabłonna boreholes, development of the Nowy Tomyśl 2k borehole, modernisation of the Paproć Natural Gas Mine (KGZ Paproć), construction of the Przyłek-KGZ Paproć gas pipeline network and construction of the Grodzisk Denitrating Plant. The total capacity of the Denitrating Plant will stand at around 35,000 m³/h. In 2008, the following tasks were completed: development of the Paproć W reserves, modernisation of KGZ Paproć and construction of the Przyłek-KGZ Paproć gas pipeline network. The expenditure incurred in 2008 was PLN 68.9m. The total value of the project is estimated at PLN 440m.

Gas Pipeline to KGHM

The project involves the construction of a high-pressure gas pipeline and optic-fibre cable along with infrastructure, from the Kościan Natural Gas Mine (KGZ Kościan) to KGHM Polkowice/Żukowice, in order to enable the Company to sell natural gas directly to KGHM Polkowice/Żukowice. The expenditure incurred in 2008 was PLN 74.9m. The total cost of the project is estimated at approx. PLN 220m.

Barnówko-Mostno-Buszewo Project

In 2008, new reserves were developed and the drilling of production boreholes on the BMB (Barnówko-Mostno-Buszewo) reserve was completed. The total expenditure incurred on the project amounted to PLN 116.78m. The investment is carried out in order to maintain crude oil production at the already exploited reserves on current levels and to ensure incremental extraction volumes following the incorporation of new reserves.

Exploration and Production Companies

The expenditure incurred on the projects of the Exploration and Production companies in 2008 amounted to PLN 564.8m. The investment activity of the companies involved primarily the development of the Skarv deposit, modernisation of the construction and technical infrastructure and purchase of specialist plant and equipment.

Other Investment Projects

Other projects provide for the development of documented or exploited natural gas reserves, maintenance and recreation of hydrocarbons production capacity or are related to the functioning of the production business segment. Key investment tasks performed in 2008 included:

- modernisation and extension of natural gas mines,
- development of the Ryłowa-Rajsko natural gas reserves,
- development of boreholes in Luchów and Wola Różaniecka,
- development of boreholes in Cierpisz,
- construction of the second section of the Kaleje-Mchy gas pipeline
- upgrading production installations at the Odolanów denitrating plant
- purchases of ready-to-use investment assets as well as backup and infrastructure.

Underground Gas Storage Facilities

In 2008, PGNiG S.A. carried out the extension of the Strachocina storage facility and launched the construction of two new nitrogen-rich gas storage facilities: Bonikowo and Daszewo. The expenditure incurred in 2008 totalled PLN 112.9m. The scope of work undertaken included:

- completion of the drilling of three horizontal boreholes and the beginning of the drilling of another borehole on the Underground Gas Storage Facility Strachocina;
- construction of a gas pipeline from the Kościan distributing centre and drilling of the Bonikowo 3H horizontal borehole; construction of the Underground Gas Storage Facility Bonikowo will allow the Company to better utilise the production capacity of its reserves and the Grodzisk blending plant;
- construction of the surface infrastructure of the Underground Gas Storage Facility Daszewo; the construction of the storage facility will ensure balanced production from local deposits.

2. Investment Projects in the Trade and Storage Segment

The projects carried out in the Trade and Storage Segment in 2008 included:

- extension of the working storage capacity of the Underground Gas Storage Cavern Facility Mogilno (a high-methane gas storage facility), modernisation of the Underground Gas Storage Facility Husów and preparatory work related to the construction of a new high-methane gas storage facility, Underground Gas Storage Cavern Facility Kosakowo (PLN 41.4m);
- projects involving transmission assets – in line with the investment plan of OGP GAZ-SYSTEM S.A. and the procedures specified in the agreement for the technical preparation and execution of projects for the purposes of the transmission system, PGNiG S.A. carried out projects involving transmission assets, which are subsequently incorporated in the register of tangible assets under lease agreements (PLN 43.6m);
- purchase of land and real property, purchase of tangible assets representing the assets of OGP GAZ-SYSTEM S.A. transferred to the Distribution System Operators and the settlement of the ownership title to and purchase of high-pressure gas pipelines (PLN 63.8m);
- telecommunications and data transmission projects and purchase of ready-to-use investment assets, vehicles, technical equipment, tools and machinery (PLN 37.1m);
- extension of the CNG fuelling station, expansion of the coverage of gas pipeline network in new regions, construction of connections to end-users and tasks related to the diversification of gas supply sources (PLN 20.6m).

3. Investment Projects in the Distribution Segment

The capital expenditure incurred in the Distribution segment amounted to PLN 879.4m. As part of their investment activity, the Gas Companies connected new customers to their grids and upgraded and expanded their gas pipeline networks. The major projects of the Distribution segment are described in Chapter V Distribution.

4. Investment Projects in the Other Activities Segment

In 2008, the capital expenditure incurred in the Other Activities segment totalled PLN 21.1m. Investments in the Other Activities segment included the extension and upgrade of real property, purchase of production plant and equipment and purchase of vehicles and computer hardware.

Chapter VIII: Environmental Protection

Liquidation of Boreholes

Pursuant to the Polish Geological and Mining Law, PGNiG S.A. is required to liquidate worked-out mining caverns, eliminate the danger and damages caused by mining activities and restore land to its original previous condition. Liquidation of boreholes and mining pits prevents leakage of crude oil and natural gas to the surface and to watercourses. In addition, there is a risk that escaping gas may accumulate in unliquidated gas boreholes, posing a fire hazard. Consequently, PGNiG S.A. liquidated 62 worked-out boreholes in 2008. The liquidated boreholes included drilling holes which were tens of years old and mining pits which dated back to the 19th century.

Carbon Credit Trade System

In 2008, in the National Plan for the Distribution of Carbon Credits for 2008–2012 (KPRU II) the facilities of PGNiG S.A. were allowed the total of 99,982 Mg CO₂ per annum. In that settlements period, the system included the plants of the Odolanów Branch, Zielona Góra Branch and the gas system of the Underground Gas Storage Cavern Facility in Mogilno

Under the existing carbon credit trading system (CCTS), in 2009 PGNiG S.A. reviewed the annual reports on carbon dioxide emissions for 2008 and brought the volumes of carbon dioxide emission in line with the amounts stipulated by the permit held. Following the cancellation of the carbon credits used in 2008, 26,597 Mg CO₂ credit units were retained.

Environmental Management System

In 2008, PGNiG S.A. started to implement the environmental management system meeting the requirements of PN-EN ISO 14001:2005 at its Warsaw head office. Within the framework of the undertaken actions, the Company carried out an initial inspection, developed a schedule concerning the implementation of the environmental management system, conducted trainings of employees and developed system procedures. In 2009, the environmental management system was implemented at the Company's head office.

REACH (Registration, Evaluation, Authorisation of Chemicals)

In order to ensure compliance with the new regulations concerning mandatory registration of chemical substances, evaluation of substances and authorisations for use of substances in production and trading, which came into effect in 2008, the Company pre-registered sulphur which is subject to the requirements of the REACH Regulation.

Natura 2000

In 2008, PGNiG S.A. continued to gather and update information on any potential environmental conflicts related to the already indicated and planned to be marked out areas of Natura 2000 and involving the planned exploration, prospecting, production projects and projects pertaining to the construction and maintenance of gas infrastructure.

Methane Emissions

In 2008, work commenced on the development of uniform CH₄ emission rates and unified calculations methods for the CH₄ emissions. The uniform and reliable methane emission rates will allow the Company to reduce the cost of environmental charges.

Chapter IX: Other Information

Distribution of 2007 Profit

On June 26th 2008, the Annual General Shareholders Meeting of PGNiG S.A. adopted a resolution on the 2007 net profit distribution in the amount of PLN 2,154.9m. Distributions from profit were allocated in the following manner:

- PLN 991.6m was allocated to the Company's statutory reserve funds
- PLN 1,121m was allocated to dividend payments (PLN 0.19 per share), including:
 - PLN 950m as non-cash dividend to the State Treasury – 29 transmission subsystems, along with their constituent and accessory parts, and PLN 5,885.30 in cash.
 - PLN 171m as cash dividend to the other shareholders
- PLN 8.4m was allocated to increase the Company's social benefits fund
- PLN 33.9m was allocated to awards for the Company employees.

The Annual General Shareholders Meeting of PGNiG S.A. set July 25th 2008 as the dividend record date and October 1st 2008 as the dividend payment date.

Approval for the Performance of Duties

On June 26th 2008, the Annual General Shareholders Meeting of PGNiG S.A. adopted resolutions on the approval of the non-consolidated financial statements and the Director's Report, on approval of the consolidated financial statements and the Director's Report on the activities of the PGNiG Group, and on granting approval to members of the Management and Supervisory Boards of PGNiG S.A. for the performance of their duties in the financial year 2007.

Agreements Concluded with Management Board Members

The employment contracts concluded with the Management Board Members appointed in 2008 contain a clause in Par. 8, which reads: "In the event of removal from office or termination of the employment contract for reasons other than breach of basic responsibilities related to employment, the employee may be granted severance pay equal to three times monthly salary." Non-competition agreements covering the period of 12 months from the date of termination of the employment relation have also been concluded with the Management Board Members. In return for compliance with the non-competition agreement during its term, Management Board member is entitled to monthly compensation of 100% of the average gross remuneration for the last three months, received while under employed.

Remuneration of Members of the Management and Supervisory Boards

For information on the remuneration paid to the Members of the Management Board and Supervisory Board see the Annual Consolidated Financial Statements for the year ended December 31st 2008 (Note 39.4).

Shares held by Members of the Management and Supervisory Boards

As at December 31st 2008, the only person holding PGNiG S.A. shares or shares in PGNiG S.A.'s related undertakings was Mr Stanisław Rychlicki, who held 8,272 PGNiG S.A. shares with the aggregate par value of PLN 8,272.

Employee Shares

On June 25th 2008, the Ministry of State Treasury disposed of one share in PGNiG S.A. The transaction was concluded on market terms. Pursuant to the Commercialisation and Privatisation Act of August 30th 1996, eligible employees gained the right to acquire the Company shares free of charge as of October 1st 2008; the right will expire on October 1st 2010. The eligible employees have the right to acquire free of charge, on the Company registration date, up to 15% of the shares acquired by the State Treasury, i.e. up to 750,000,000 Series A1 bearer shares in PGNiG S.A., with a par value of PLN 1 per share. The Company shares acquired free of charge by the eligible employees cannot be traded before July 1st 2010, and the shares acquired free of charge by members of the Company's Management Board cannot be traded before July 1st 2011. Following the acquisition of 15% of the Company shares by its employees, the State Treasury's percentage share in the total vote in the Company will decline from 84.75% to 72.03%. The process of concluding agreements for the free of charge disposal of shares to the eligible employees commenced on April 6th 2009.

Actions Against PI GAZOTECH Sp. z o.o.

- On March 7th 2006, the Regional Court of Warsaw dismissed PGNiG S.A.'s action instituted against PI GAZOTECH Sp. z o.o. to rescind or assert invalidity of the resolutions of the General Shareholders Meeting of PI GAZOTECH Sp. z o.o., dated April 23rd 2004, including the resolution whereunder PGNiG S.A. is obliged to pay additional contributions in the amount of PLN 52m. In view of the dismissal, PGNiG S.A. filed an appeal against the court ruling, which was rejected by the Court of Appeals in Warsaw on January 10th 2007 on account of the Company's failure to duly paid the required fees. On March 1st 2007, PGNiG S.A. filed a complaint with the Supreme Court regarding the Court of Appeals' ruling. On July 20th 2007, the Supreme Court examined the complaint in closed session and overruled the Court of Appeals's decision to reject PGNiG's appeal. On February 4th 2008, the Court of Appeals dismissed PGNiG's appeal. The decision is final and binding. From the date of passing the verdict by the Court of Appeals the Company's claim is no longer secured by suspension of the resolution authorising the additional contributions. On July 8th 2008, a cassation complaint against the decision of the Court of Appeals of February 4th 2008 was filed. On February 26th 2009, the Supreme Court issued a decision to accept the cassation complaint for consideration.
- On December 7th 2006, the Regional Court of Warsaw dismissed PGNiG's action instituted against PI GAZOTECH Sp. z o.o. to confirm the non-existence of the resolution on redemption of shares, adopted by the General Shareholders Meeting of PI GAZOTECH Sp. z o.o. on April 23rd 2004. PGNiG S.A. filed an appeal against the ruling. The Court of Appeals in Warsaw dismissed the appeal at the hearing of February 5th 2008. The decision is final and binding. On May 27th 2008, a cassation complaint against the decision of the Court of Appeals of February 5th 2008 was filed. By virtue of its decision of December 5th 2008, the Supreme Court refused to accept the cassation complaint for consideration.
- The proceedings based on PGNiG S.A.'s action against PI GAZOTECH Sp. z o.o. to rescind or assert invalidity of the resolution of the General Shareholders Meeting of PI GAZOTECH Sp. z o.o., dated January 19th 2005, whereunder PGNiG S.A. is obliged to pay additional contributions in the amount of PLN 25,999,998, held before the Regional Court of Warsaw. On October 27th 2008, a hearing was held before the Regional Court of Warsaw. By virtue of its decision of October 31st 2008, the Regional Court dismissed the Company's claim. PGNiG S.A. filed an appeal from the decision. The claim remained to be secured until the decision becomes final.
- The proceedings based upon PGNiG S.A.'s action against PI GAZOTECH Sp. z o.o. to rescind or assert invalidity of the resolution of the General Shareholders Meeting of PI GAZOTECH Sp. z o.o., dated October 6th 2005, whereunder PGNiG S.A. is obliged to pay additional contributions in the amount of PLN 6,552,000, instigated before the Regional Court of Warsaw were concluded

in the first instance. On May 30th 2008, the Regional Court dismissed the Company's claim and reversed the decision on securing this claim. On July 22nd 2008, PGNiG S.A. lodged a complaint against the reversing of the decision on securing its claim, and on July 29th 2008, it filed appeal against the Regional Court's judgement. On November 12th 2008, the Court of Appeals accepted the Company's complaint against the reversing of the decision on securing its claim. On January 14th 2009, while reconsidering PI GAZOTECH Sp. z o.o.'s motion to reverse the decision on securing the claim (after the Court of Appeals overruled the decision on reversing the decision on securing the claim), the Regional Court of Warsaw again reversed the decision on securing the claim. On February 17th 2009, PGNiG S.A. lodged a complaint against the above decision of the Regional Court of Warsaw.

Dispute with Bartimpex S.A.

On August 9th 2005, in connection with a motion filed by PHZ Bartimpex S.A., the President of the Anti-Trust and Consumer Protection Authority ruled that the Company pursues anti-competitive practices through abusing its dominant position on the domestic natural gas transmission market, this being manifested in the refusal to provide the services of transmitting natural gas extracted outside Poland. The President of the Anti-Trust and Consumer Protection Authority also stated the abovementioned practices ceased as of June 2nd 2003. By virtue of his decision of August 9th 2005, the President of the Anti-Trust and Consumer Protection Authority imposed a fine on PGNiG S.A. in the amount of PLN 2,000,000 along with an order to repay the costs of proceedings for the benefit of PHZ Bartimpex S.A.

On August 31st 2005, PGNiG S.A. appealed against the decision. As a consequence, on January 31st 2007 the Regional Court of Warsaw issued a verdict reducing the fine imposed on PGNiG S.A. to the amount of PLN 500,000.

Both parties filed appeals against the ruling of the court of first instance. The Court of Appeals changed the Regional Court's decision. Accordingly, a fine of PLN 2,000,000 was imposed and PGNiG's appeal was dismissed. On September 1st 2008, PGNiG S.A. filed a cassation complaint against the decision of the Court of Appeals of March 27th 2008 was filed. The Supreme Court accepted the Company's cassation complaint for consideration.

Dispute with EUROPOL GAZ S.A.

The proceedings based upon PGNiG S.A.'s actions against EUROPOL GAZ S.A. to receive payment of interest due under agreement no. DF/33/95, dated September 25th 1995, on a loan and guarantee to finance the construction of a system of transmission pipelines, have been pending since February 27th 2004. On March 31st 2006, the Regional Court of Warsaw passed a decision whereby PGNiG S.A. was to receive PLN 32,699,276.36 with statutory interest accrued from February 27th 2004 to the payment date, and PLN 107,200 as costs of proceedings. EUROPOL GAZ S.A. appealed against the decision. On December 7th 2006, the Court of Appeals in Warsaw overruled the decision and submitted the case for re-examination by the Regional Court of Warsaw, which was also to decide on costs of the appellate instance. By way of submitting a letter of April 23rd 2007, PGNiG S.A. modified its claim to the effect that it demanded PLN 36,618,037.33 and withdrew its claim concerning payment of PLN 2,382,581.66, due to the statute of limitation. On July 2nd 2007, the Regional Court of Warsaw rejected the claim for payment of PLN 36,618,037.33, discontinued the proceedings concerning payment of PLN 2,382,581.66, and decided that PGNiG S.A. is to cover costs of proceedings of PLN 119,815 to EUROPOL GAZ S.A. On July 30th 2007, PGNiG S.A. appealed against this decision. On November 15 2007, the Court of Appeals in Warsaw dismissed the appeal. The decision is final and binding. On March 20th 2008, a cassation complaint was filed against the Court of Appeals's decision. By virtue of its decision of October 17th 2008, the Supreme Court dismissed the cassation complaint.

Dispute with EMFESZ NG Sp. z o.o.

On March 9th 2006, proceedings before the President of URE were instigated upon a motion filed by EMFESZ NG Polska Sp. z o.o. regarding refusal to execute an agreement on provision of gaseous fuel storage services. On June 11th 2007, a team of URE experts completed their work aimed at preparing an expert opinion on the technological feasibility of provision of gas storage services by PGNiG S.A. to third parties. On August 24th 2007, the President of URE announced that the relevant decision would be made by October 24th 2007.

Afterwards, by virtue of subsequent documents, the President of URE was continuously postponing this date up to February 24th 2008. On February 25th 2008, he passed a resolution suspending the proceedings until the decision of the European Commission on the introductory issue regarding examination of the President of URE's stand on PGNiG's request for temporary exemption from the obligation to store gaseous fuels.

Chapter X: Financial Standing

1. Financial Performance in 2008

The 2008 financial statements of PGNiG S.A. and the 2008 consolidated financial statements of the PGNiG Group have been audited by Deloitte Audyt Sp. z o.o. The agreement with the auditor was concluded on August 16th 2007 for a term of three years (2007–2009). The scope of the auditor's responsibilities includes:

- auditing financial statements for 2007, 2008 and 2009,
- reviewing financial statements for Q1 2008, Q1 2009 and Q1 2010,
- reviewing financial statements for H1 2007, H1 2008 and H1 2009, and
- reviewing financial statements for three quarters of 2007, three quarters of 2008 and three quarters of 2009.

The table below shows the auditor's fee paid or payable for the years 2007–2008:

The auditor's fee (PLN)

	2008	2007
Audit of the annual financial statements	330,000	390,000
Other confirmation services, including review of financial statements	540,000	440,000
Tax advisory services	-	-
Other services	288,124	25,881

1.1. Key Business and Financial Information

The 2008 net profit of the PGNiG Group stood at PLN 865.7m, up by PLN 50.4m (or 6%) compared with the figure posted in 2007.

Summary information on the PGNiG Group's financial standing in 2008, compared with 2007, is presented in the following financial statements prepared in accordance with the International Financial Reporting Standards:

- the balance sheet,
- the income statement,
- the cash flow statement,
- the selected financial ratios.

Directors' Report on PGNiG Group's Operations in 2008

Consolidated Balance Sheet (PLNm)

ASSETS	Dec 31st 2008	Dec 31st 2007
Non-current assets	22,573.6	22,131.1,
Property, plant and equipment	20,587.0	18,715.5
Investment property	8.2	10.6
Intangible assets	151.7	84.6
Investments in associated undertakings valued with equity method	556.9	557.5
Financial assets available for sale	42.9	20.0
Other financial assets	676.6	2,292.2
Deferred tax asset	514.9	419.8
Other non-current assets	35.4	30.9
Current assets	7,171.7	6,270.8
Inventories	1,721.3	1,216.0
Trade and other receivables	3,716.9	3,331.0
Current income tax receivable	59.6	17.5
Prepayments and accrued income	70.3	82.4
Financial assets held for sale	6.5	22.4
Derivative financial instrument assets	174.2	17.4
Cash and cash equivalents	1,421.9	1,583.6
Assets available for sale	1.0	0.5
Total assets	29,745.3	28,401.9
Equity	20,715.9	21,021.8
Share capital	5,900.0	5,900.0
Currency-translation differences on foreign-currency undertakings	(39.1)	(44.5)
Share premium account	1,740.1	1,740.1
Other reserve funds	10,729.1	3,478.1
Retained earnings/(deficit)	2,376.8	9,939.4
Equity (attributable to equity holders of the parent)	20,706.9	21,013.1
Equity attributable to minority interests	9.0	8.7
Non-current liabilities	4,058.7	3,879.5
Loans, borrowings and debt securities	41.1	31.4
Provisions	1,501.9	1,153.8
Deferred income	1,139.3	1,142.4

Directors' Report on PGNiG Group's Operations in 2008

Deferred tax liability	1,352.3	1,530.3
Other non-current liabilities	24.1	21.6
Current liabilities	4,970.7	3,500.6
Trade and other payables	3,222.5	2,408.0
Loans, borrowings and debt securities	871.8	106.7
Liabilities under derivative financial instruments	16.7	36.2
Current tax liability	47.5	281.4
Provisions	173.4	181.2
Deferred income	638.8	487.1
Total liabilities	9,029.4	7,380.1
Total equity and liabilities	29,745.3	28,401.9

Directors' Report on PGNiG Group's Operations in 2008

Condolidated Income Statement (PLNm)

	2008	2007
Sales revenue	18,432.0	16,652.1
Total operating expenses	(17,631.3)	(15,791.1)
Raw materials and energy used	(11,631.7)	(8,331.6)
Employee benefits	(2,161.9)	(2,014.1)
Depreciation and amortisation	(1,424.9)	(1,430.3)
Contracted services	(2,789.1)	(2,692.5)
Cost of products and services for own needs	739.0	687.0
Other net operating expenses	(362.7)	(2,009.6)
Operating profit	800.7	861.0
Financial income	213.2	248.2
Financial expenses	(78.8)	(90.5)
Share in profit/(loss) of undertakings valued with equity method	0.2	(16.0)
Pre-tax profit	935.3	1,002.7
Corporate income tax	(69.6)	(86.6)
Net profit	865.7	916.1
Discontinued operations	-	-
Operating profit/(loss) from discontinued operations	-	-
Net profit for the year	865.7	916.1
attributable to:		
equity holders of the parent	865.3	915.1
minority interests	0.4	1.0
	865.7	916.1

Directors' Report on PGNiG Group's Operations in 2008

Consolidated Cash Flow Statement (PLNm)

	2008	2007
Net cash provided by/used in operating activities	1,492.9	3,028.9
Net cash provided by/used in investing activities	(2,208.9)	(2,455.6)
Net cash provided by/used in financing activities	552.0,	(2,547.6)
Change in net cash	(164.0)	(1,974.3)
Cash and cash equivalents at beginning of period	1,584.9	3,559.2,
Cash and cash equivalents at end of period	1,420.9	1,584.9

Financial Ratios

Profitability Ratios

	2008	2007
EBIT (PLNm) operating profit	800.7	861.0
EBITDA (PLNm) operating profit + depreciation/amortisation	2,225.6	2,291.3
ROE (Return on Equity) net profit * to equity at end of period	4.2%	4.4%
NET MARGIN net profit * to sales revenue	4.7%	5.5%
ROA (Return on Assets) net profit * to assets at end of period	2.9%	3.2%

*net profit for the financial year attributable to equity holders of the parent

Liquidity Ratios

	2008	2007
CURRENT RATIO current assets (net of prepayments and accrued income) to current liabilities	1.4	1.8
QUICK RATIO current assets (net of prepayments and accrued income) decreased by inventories to current liabilities	1.1	1.4

Debt Ratios

	2008	2007
DEBT RATIO total liabilities to total equity and liabilities	30.4%	26.0%
DEBT/EQUITY RATIO total liabilities to equity *	43.6%	35.1%

* equity attributable to equity holders of the parent

1.2. Overview of the Financial Performance

The Group's operating profit decreased by PLN 60.3m (or 7%) relative to 2007. However, the 2007 revaluation of the Gas Companies's assets eroded the profit by PLN 1,317.3m.

The result on operating activities was primarily impacted by lower profit margins on high-methane gas, caused by the following factors:

- a 37% rise in unit purchase costs of imported gas
- an 11% rise in the volume of imported gas
- a mismatch between the tariff rates for gaseous fuels and purchase costs of imported gas.

The rise in unit purchase costs of imported gas was driven by the growing prices of crude oil and petroleum products on international markets, and the dollar exchange rates. The surge in crude oil prices peaked in June 2008. Despite a considerable fall in crude oil prices in the subsequent months, the highest increase in price of imported gas was recorded in Q4 2008. This followed from the fact that prices of imported gas are indexed to a nine-month moving average price of petroleum products. Another driver of imported gas prices were changes on the FX markets, in particular the depreciation of the zloty against the US dollar seen in H2 2008.

In the discussed period, the Group imported higher volumes of gas, which was driven by the following factors:

- a 2% rise in volumes of high-methane gas sold
- a 38% decrease in use of gas from underground storage facilities
- a 6% decrease in high-methane gas production.

Increased demand for gaseous fuels on the domestic market, caused by lower air temperatures in the 2008 heating season, translated into increased sales of high-methane gas. A significantly lower drawing of gas from the underground storage facilities relative to 2007 was caused by optimised management of import contracts, supply of sufficient amounts of gas during the interruptions in gas imports, and storage of larger volumes of gas to meet a possible rise in demand for gas in the following heating season. The decrease in high-methane production was an effect of natural deterioration of the geological conditions in the producing fields, including the flooding of boreholes, and launch of new, relatively small fields.

In 2008, the President of URE approved the changes in tariffs for gaseous fuels twice. This led to an increase in the selling price of gaseous fuels by 14.3% in April, and 11.1% in October. However, the selling prices defined in the new tariffs did not make up for the increase in the purchase costs of imported gas. As a result, the PGNiG Group recorded a loss on sales of high-methane gas in 2008.

Segments' Operating Results

The Group was able to maintain its stable financial position mainly due to the performance of its production business. In 2008, the operating profit of the Exploration and Production Segment amounted to PLN 918.4m and was PLN 100.7m (10%) lower year on year. The decrease was primarily attributable to higher expenditure on exploratory and geological projects, higher expenditure on boreholes classified as negative, charged to cost, as well as an increase in provisions for borehole liquidation. In 2008, production volumes for nitrogen-rich natural gas and crude oil decreased owing to natural deterioration of geological and mining conditions, a technical failure at the Dębno mine, and lower production forced by a technical failure at one of the customers'. Sales of nitrogen-rich gas decreased by 3% and of crude oil by 8%, year on year. Despite the smaller production, the Group was able to maintain its profitability owing to the higher prices of the produced hydrocarbons. The selling price of nitrogen-rich gas was increased twice, while the price of crude oil was tightly linked to crude oil prices on global markets.

Directors' Report on PGNiG Group's Operations in 2008

The Group's Trade and Storage Segment recorded an operating loss of PLN 509.9m, which means a PLN 1,696.9m drop on 2007. This was caused by lower profitability of high-methane gas sales brought about by higher unit prices of imported gas, larger volumes of gas imports, and the mismatch between tariff prices and charges for gaseous fuels on the one hand and gas acquisition cost on the other.

In 2008, the Group's Distribution Segment posted an operating profit of PLN 418.7m. The PLN 1,729.8m year-on-year rise was attributable to the revaluation of the Gas Companies' assets. Net of this effect, the operating profit of the Distribution Segment increased by PLN 412.5m as a result of approval of the new tariffs for the Gas Companies at the end of April 2008, with the simultaneous decrease in the volume of transmitted gas.

PGNiG Group's segments (PLNm)

2008	Exploration and Production	Trade and Storage	Distribution	Other activities	Eliminations	Total
Sales to external customers	2,129.2	16,116.2	27.7	158.9	-	18,432.0
Inter-segment sales	1,429.7	603.6	3,031.6	206.0	(5,270.9)	-
Segment's total revenue	3,558.9	16,719.8	3,059.3	364.9	(5,270.9)	18,432.0
Segment's cost and expenditure	(2,640.5)	(17,229.7)	(2,640.6)	(352.2)	5,231.7	(17,631.3)
Operating profit/(loss)	918.4	(509.9)	418.7	12.7	(39.2)	800.7
Net financial expenses	-	-	-	-	-	134.4
Share in profit of undertakings valued with equity method	-	0.2	-	-	-	0.2
Pre-tax profit/(loss)						935.3
Corporate income tax	-	-	-	-	-	(69.6)
Net profit/(loss)						865.7

PGNiG Group's segments (PLNm)

2007	Exploration and Production	Trade and Storage	Distribution	Other activities	Eliminations	Total
Sales to external customers	2,054.2	9,468.8	5,013.7	115.4	-	16,652.1
Inter-segment sales	1,475.1	4,416.2	1,643.6	218.3	(7,753.2)	-
Segment's total revenue	3,529.3	13,885.0	6,657.3	333.7	(7,753.2)	16,652.1
Segment's cost and expenditure	(2,510.2)	(12,698.0)	(7,968.4)	(325.3)	7,710.8	(15,791.1)
Operating profit/(loss)	1,019.1	1,187.0	(1,311.1)	8.4	(42.4)	861.0
Net financial expenses	-	-	-	-	-	157.7
Share in profit of undertakings valued with equity method	-	(16.0)	-	-	-	(16.0)
Pre-tax profit/(loss)						1,002.7
Corporate income tax	-	-	-	-	-	(86.6)
Net profit/(loss)						916.1

The operating result was also significantly affected by a PLN 1,646.9m decrease in net other operating expenses relative to 2007. Net of the effect of the assets revaluation, other operating expenses decreased by PLN 329.6m. The decrease was attributable to significantly higher net gain from revaluation of tangible assets, mostly connected with the production activity, higher net foreign exchange gains, and the net result on valuation and execution of derivative transactions.

In 2008, the PGNiG Group financial performance deteriorated, as reflected in the basic profitability ratios. Return on equity decreased from 4.4% to 4.2%, return on assets from 3.2% to 2.9%, while net margin fell from 5.5% to 4.7%.

As at December 31st 2008, the balance-sheet total was PLN 29,745.3m, i.e. PLN 1,343.4m (5%) higher than at the end of 2007.

The largest item of assets represented property, plant and equipment, which, as at the end of 2008, stood at PLN 20,587.0m and was by PLN 1,871.5m (10%) higher than a year earlier. The increase in property, plant and equipment was principally attributable to the revaluation of the Gas Companies' assets in 2007 and the PGNiG Group's investing activity. The value of property, plant and equipment was also affected by excluding the distribution-related assets from operating lease and contributing the to the Gas Companies.

As at December 31st 2008, other financial assets were by PLN 1,615.6m (71%) lower than at the end of 2007, owing to lower non-current receivables under operating lease, resulting from excluding the distribution-related assets from operating lease, payment of non-cash dividend to the State Treasury, and continued repayment of lease instalments by OGP GAZ-SYSTEM S.A.

As at December 31st 2008, current assets stood at PLN 7,171.7m and were by PLN 900.9m (14%) higher than at the end of 2007.

Trade and other receivables increased by PLN 385.9m (12%) between December 31st 2007 and December 31st 2008, owing to higher sales revenue attributable to increased prices of natural gas and the larger volume of gaseous fuel sales.

In 2008, inventories increased by PLN 505.3m (42%). Inventories disclosed in the balance sheet principally represent gas stored in the underground storage facilities. The increase in inventories was brought about by the larger volumes of stored gas and the higher gas acquisition prices.

As at December 31st 2008, assets under financial derivatives were by PLN 156.8m higher than at the end of 2007, owing to the larger gain on valuation of hedging transactions.

As at December 31st 2008, cash and cash equivalents stood at PLN 1,421.9m, PLN 161.7m (10%) down on 2007, mostly due to high operating losses incurred in Q4 2008. In order to maintain its current liquidity, the Group increased its current liabilities under loans and borrowings by PLN 764.0m.

The deteriorated financial standing of the Group affected liquidity ratios. The current ratio dropped from 1.8 to 1.4, while the quick ratio fell from 1.4 to 1.1. Despite the decline in liquidity ratios, the value and structure of current assets held by the PGNiG Group still enables it to settle all its current liabilities in a timely manner.

The main financing source of the Group's assets was equity, whose value dropped by PLN 305.9m (2%) relative to December 31st 2007. The change was largely caused by net profit generated during the year (PLN 865.7m) and distribution of the previous year's profit in the form of non-cash and cash dividend (PLN 1,121.0m).

Non-current provisions disclosed in the balance sheet were by PLN 348.1m (30%) higher than a year earlier, mostly due to the increased provisions for borehole liquidation.

As at December 31st 2008, current liabilities were by PLN 1,470.1m (42%) higher than at the end of 2007, which was mainly caused by contracting a short-term loan under the syndicated loan agreement, increased liabilities under gas purchases (due to the increased prices of imported gas) and increased deferred income on estimated future gas sales.

The increased level of external financing recorded at the Group brought about changes in the ratios reflecting the relation between capital and other items of equity and liabilities. The total debt-to-equity ratio advanced from 35.1% to 43.6%, while the debt ratio (total liabilities to total equity and liabilities) increased from 26.0% to 30.4%.

Material Off-Balance-Sheet Items

As at December 31st 2008, the PGNiG Group's most important off-balance-sheet item comprises contingent liabilities, which stood at PLN 11,108.8m. The main item under contingent liabilities are the guarantees granted by the Gas Companies by way of security for the syndicated loan granted to PGNiG S.A.

The Use of Issue Proceeds until December 31st 2008

As a result of the Public Offering, in 2005 PGNiG S.A. earned issue proceeds totalling PLN 2,682.0m. Net of the amount of PLN 41.9m representing the issue's costs, net proceeds amounted to PLN 2,640.1m.

The aggregate expenditure of the funds obtained from the public issue of shares at the end of 2008 totalled PLN 2,158.4m, which accounted for 82% of total proceeds. The breakdown of the expenditure was as follows: PLN 31.8m was spent by the end of 2005, PLN 1,292.3m was spent in 2006, PLN 525.6m in 2007, and PLN 308.7m in 2008.

The use of proceeds from the public issue of shares in individual business segments:

- upstream – PLN 1,078.5m
- trade, transmission and storage – PLN 578.0m
- distribution – PLN 369.9m
- debt repayment (5% of the issue proceeds) – PLN 132m.

The key projects implemented with the use of issue proceeds in 2008 were:

- increasing the capacities of underground gas storage facilities in Swarzędz, Mogilno, Wierzchowice and Strachocin, and investment in transmission assets included in the list of fixed assets under a lease agreement.
- Modernisation and extension of distribution network carried out by the Gas Companies.

As at the end of 2007, the total limit set in the Issue Prospectus for expenditure on upstream activities was exhausted.

Feasibility of Investment Plans

The PGNiG Group holds financial resources in the form of bank deposits as well as current investments in treasury debt securities, which are easily available for sale. The balance of available funds lends flexibility to the Group in implementing its investment plans. A low financial leverage and positive assessment of the PGNiG S.A.'s risk, as confirmed by the rating agencies, combined with appropriate creditworthiness, enable the Group to finance potential further projects using bank loans and debt issues.

Transactions concluded on terms deviating from the market terms

In 2008, PGNiG S.A. and its subsidiaries did not enter into any material related party transactions on terms deviating from the market terms (Note 39.1. to the Annual Consolidated Financial Statements for the Financial Year Ended December 31st 2008).

Explanation of discrepancies between the actual results and forecasts for 2007.

In 2008, the Company did not publish any forecasts.

2. Financial Management

The funds at the disposal of the PGNiG Group guarantee the financing of all current and planned expenses related to the Group's current and investing activities. Although no risk of liquidity loss occurs, in order to enhance security the Group has concluded current account loan agreements, as well as a syndicated loan agreement (dated July 27th 2005) providing for a revolving multi-currency credit facility of EUR 600m. As at December 31st 2008, the debt under the syndicated loan amounted to EUR 191.3m.

2.1. Current Investments

In 2008, free cash was invested in instruments involving minimum credit risk, i.e. treasury securities and deposits with commercial banks with investment grade rating.

Investments in debt securities issued by the State Treasury represented approximately 77% of the transaction volume. The financial investments made in 2008 were current investments, maturing in up to three months, which was consistent with PGNiG S.A.'s financial investment policy and the objectives specified in the issue prospectus.

2.2. Loan Agreements

In 2008, the PGNiG Group entered into loan agreements totalling PLN 225.2m and CZK 10m. The loans were used mainly to finance day-to-day operations. The table below sets forth the details of the key loan agreements executed by the PGNiG Group in 2008.

Key loan agreements concluded by the PGNiG Group in 2008:

Bank	Loan amount (million)	Currency	Interest rate	Type	Maturity date
Bank Handlowy S.A.	40	PLN	WIBOR T/N + 0.8%	working capital loan	Dec 31 2009
Millennium S.A.	40	PLN	WIBOR 1M + 0.8%	working capital loan	Dec 18 2009
PKO BP S.A.	30	PLN	WIBOR 1M + 0.2%	working capital loan	Apr 22 2009
ING Bank Śląski S.A.	12	PLN	WIBOR 1M + 0.65%	working capital loan	Aug 27 2009
PEKAO SA	25	PLN	WIBOR 1M + 0.3%	working capital loan	Dec 31 2009
Millennium S.A.	10	PLN	WIBOR 1M + 0.50%	working capital loan	Dec 23 2009
BGK	25	PLN	WIBOR 3M + 0.3%	working capital loan	May 31 2010

In 2008, the PGNiG Group did not advance any loans.

2.3. Guarantees and Sureties

In 2008, the PGNiG Group provided 43 guarantees for a total amount of PLN 368.7m, most of which were issued to:

- National Oil Corporation Libya, for PLN 319.9m (USD 108m), to secure the performance of licence obligations by POGC Libya B.V.
- Cairn Energy (India), GSPC (India), Oil India (India), Adani Welspun (Thailand), for PLN 29.8m, to secure proper performance of the contract by GEOFIZYKA Toruń Sp. z o.o.

In 2008, the PGNiG Group was issued guarantees for a total amount of PLN 279.2m. The most important of the guarantees were those issued by:

- PBG S.A. – PLN 85.2m as performance bond for the project named “LMG Project – Central facilities, borehole areas, pipelines and other infrastructure”.
- Consortium comprising PBG SA Przeźmierowo, Tecnimont S.p.A., Societe Francaise d'Etudes et de Realisations d'Equipements Gaziers SOFREGAZ, Plynostav Pardubice Holding A.S., Plynostav – Regulace Plynu A.S. – PLN 66.4m as performance bond concerning the project named “Construction of the Above-Ground Part of the Wierzchowice Underground Gas Storage Facility, phase: 3.5bn nm³, sub-phase: 1.2bn nm³”
- Lux Veritatis Foundation – PLN 14.0m as guarantee of payment for drilling services at geothermal well Toruń TG-1, provided by PNiG Jasło Sp. z o.o.
- K.D.P. Sp. z o.o. – PLN 28.5m, as security for natural gas supplies.

2.4. Financial Risk Management

The main objective of the PGNiG Group's financial risk management policy is to limit the volatility of the cash flows related to the Group's operations to the acceptable levels in the short and mid term and building the firm value in the long term.

The Company limited the volatility of the cash flows resulting from payments under concluded gas purchase agreements and the payments resulting from repayment of the Company's credit liabilities in 2007 by concluding transactions hedging the foreign exchange risk (FX options, option strategies).

In 2008, the PGNiG Group used the following financial instruments to manage the price risk:

- FX forwards,
- purchased foreign exchange call options,
- option strategies – generally representing combinations of at least two FX options,
- cross currency interest rate swaps.

The following was undertaken by the PGNiG Group to mitigate the credit risk:

- investment of free cash in instruments with a minimum credit risk (treasury bills and treasury bonds);
- cooperation with the leading commercial banks;
- conclusion of framework agreements with business partners, which expressly define the rights and obligations of the parties;
- diversification of business partners;
- cooperation with rating agencies.

The measures undertaken by the PGNiG Group to mitigate the risk of cash-flow disruptions included:

- diversification of e-banking systems;
- on-going control of credit/debit operations on bank accounts;
- gathering information on cash flows at the Company/the Group;

- consolidation of bank accounts;
- conclusion of current account facility agreements.

To mitigate the risk of losing financial liquidity, the Group undertook measures which included:

- conclusion of current account loan agreements;
- projections of cash flows at the Company/the Group;
- estimation of the condition and the value of assets available for sale;
- maintenance of highly liquid financial assets.

In 2008, PGNiG S.A. did not apply hedge accounting. However, most of the concluded transactions were effective in terms of hedge accounting (according to IAS 39).

3. Financial Forecasts

The main factors impacting the PGNiG Group's financial performance will include crude oil prices on international markets, position of the President of URE on gaseous fuel tariffs, as well as the situation on foreign-exchange markets.

Since August 2008, the fuel market has witnessed a steep fall in crude oil prices, which will contribute to a reduction in import prices of gas in the coming months.

The tariff approved in October 2008 did not offset the sharp increases in imported gas prices observed in Q4 2008 and the resulting substantial losses on sales of high-methane natural gas incurred by the Group. Despite the fall in imported gas prices anticipated since January 2009, the sales of high-methane natural gas will continue to be unprofitable. Lower gas prices may positively contribute to the financial results of the PGNiG Group no sooner than in Q3 2009.

On February 13th 2009, PGNiG S.A. applied to the President of URE for a change of the gaseous fuel tariff. The financial standing of the PGNiG Group in the coming quarters will largely depend on whether the President of URE approves new tariffs, providing cover for the costs of imported gas.

The PGNiG Group's financial performance is materially affected by the situation on foreign-exchange markets. The second half of 2008 saw a clear rise in the exchange rate of the US dollar against the Polish zloty. The stronger dollar has an adverse effect on the cost of imported high-methane natural gas. As the risk related to fluctuations in exchange rates is high, the Group will seek to mitigate its impact through active and consistent financial risk management.

The volume of natural gas sales is determined by the pace of the country's economic growth. A potential drop in gas demand may have a positive bearing on the financial performance of the PGNiG Group.

The PGNiG Group still assumes that production of natural gas will be highly profitable; the level of own production should be similar to the volumes reported in the previous year. The profitability of crude oil sales will depend on oil prices on international markets.

In 2009, the PGNiG Group plans to increase capital expenditure, chiefly on projects aimed at increasing the production capacity, diversifying gas supply sources and expanding underground gas storage facilities. The Group plans to increase capital expenditure on power projects using natural gas. Moreover, it will also intensify its efforts designed to search for and prove new oil and gas reserves. The wide-ranging investment activities will be financed from operating cash flows and available credit facilities.

Members of the Management Board

President	Michał Szubski	_____
Vice-President	Mirosław Dobrut	_____
Vice-President	Radosław Dudziński	_____
Vice-President	Sławomir Hinc	_____
Vice-President	Mirosław Szkałuba	_____
Vice-President	Waldemar Wójcik	_____