



Energa

**ASSESSMENT OF THE STANDING
OF ENERGA SA
AND THE ENERGA GROUP**

in the financial year 2016

Warsaw, May 2017

Table of contents

1.	Assessment of the standing of ENERGA SA	3
2.	Assessment of the standing of the ENERGA Group.....	5
3.	Assessment of the internal control system and the key risk management system	6

1. Assessment of the standing of ENERGA SA

The Supervisory Board evaluates the standing of ENERGA SA as positive. In the financial year 2016, there were no negative events that would endanger the continuity of business activity or cause deterioration of the financial standing. The Company's stable financial position is confirmed by BBB and Baa1 ratings awarded by Fitch and Moody's, respectively.

The net result of ENERGA SA for the financial year 2016 reached PLN 784 m, which was 7% less than the net profit earned in 2015.

Most of the Company's revenues originated from dividends and services provided to other Group Companies. In 2016, ENERGA SA posted:

- 1) sales revenues of PLN 68 m, 13% more than in 2015, primarily as a result of an increase in revenues on marketing and ICT activities conducted for Group companies;
- 2) other operating revenue of PLN 12 m, 8% less than in 2015, mainly due to absence of the profit earned on the sale of property, plant and equipment in 2016 (PLN -4 m), offset by settlement of the grant from NCBiR for research and development activity (PLN 3 m);
- 3) financial income of PLN 1,098 m, 4% lower costs than in 2015, mainly due to the PLN 40 m decrease in dividend income. At the same time, interest was down by PLN 6 m associated with valuation of the hedging derivatives.

In 2016, the Company incurred:

- 1) cost of sales of PLN 51 m, i.e. 7% less than in 2015;
- 2) general and administrative expenses of PLN 81 m, i.e. 6% less than in 2015, which is related mainly to lower costs of foreign services and lower level of non-deductible VAT;
- 3) financial costs of PLN 266 m, i.e. 1% more than in 2015;
- 4) other operating expenses of PLN 15 m, i.e. 88% more than in 2015. The increase results from payment of a donation in 2016 in the amount of PLN 7 m to the newly established Polish National Foundation.

As at 31 December 2016, ENERGA SA's total assets were PLN 14,380 m and were PLN 1,837 (15%) higher than on 31 December 2015. Significant changes were related to the acquisition of stakes in subsidiaries (ENERGA Kogeneracja Sp. z o.o., Elektrownia Ostrołęka SA and ENERGA Invest SA), which was associated with ownership changes within the Group.

At the same time, the value of investments in bonds issued by subsidiaries declined. The increase in assets and liabilities was driven by the one-way zero-balancing cash pooling service launched in 2016 January 2016 for funds denominated in Polish zloty.

The increase of liabilities on account of loans and borrowings was associated with the drawdown of the financing from EBRD in the amount of PLN 276 m in 2016, which was partly compensated by repayment of the liabilities incurred in previous years.

As at 31 December 2016, non-current assets represented 77% of total assets and current assets represented 23% of total assets, whereas at the end of the previous year they represented 87% and 13%, respectively. The increase in current assets in 2016 was driven primarily from the increase in cash which was associated with the launched cash-pooling service.

As at 31 December 2016, equity represented 50% of all liabilities and equity (52% as at the end of 2015). The remaining part of liabilities and equity was comprised of liabilities, with the highest portion attributable to financial liabilities.

The settlement of the ENERGA SA 2015 result increased the reserve capital and supplementary capital in 2016 by PLN 571 m and PLN 67 m, respectively. The Company allocated PLN 203 m for dividends distributed to shareholders. As at 31 December 2016, equity covered 49.6% of the Company's assets, compared to 52.0% as at the end of 2015.

The balance of ENERGA SA's cash and cash equivalents as at 31 December 2016 was PLN 1,295 m, up by PLN 821 m from the end of 2015.

As at 31 December 2016 ENERGA SA was listed in the following stock exchange indices: WIG, WIG20, WIG30, WIG-Energia, WIGdiv, WIG-Poland, and international indices: RESPECT Index, FTSE All, FTSE4Good Emerging Index and MSCI Global Sustainability Indexes. ENERGA SA proved once again that it is a socially responsible company, managed according to the best standards. In December 2016, ENERGA SA was included for the third time in the RESPECT index (which groups listed companies committed to social responsibility and managed according to the best standards) and in the FTSE4Good Emerging Index. This is an index grouping companies from more than 20 emerging economies that are selected on the basis of compliance of their operations with the environmental, social responsibility and corporate governance criteria.

ENERGA SA was also included in the "70 Emerging Markets" ranking compiled by the rating agency Vigeo Eiris. The ranking presents 70 companies from emerging markets with the highest environmental, social and corporate governance scores.

The study included more than 850 companies from 37 sectors in 31 countries. In 2016, the Company was engaged in active communication with investors. As part of its periodic activities, the Company published 4 periodic reports and 55 current reports, held 4 performance conferences with online broadcast and the Company's representatives held over 100 one-on-one meetings with institutional investors (within the framework of investor conferences and non-deal roadshows).

In addition, a "study tour" in Gdańsk for a group of analysts and institutional investors, and investors chat with a Management Board members (addressed mainly to individual investors) were organized.

The actions taken to increase the effectiveness of communication resulted in awards and distinctions.

On 8 December 2016 the Company entered into an Investment Agreement with ENEA SA and Elektrownia Ostrołęka SA regarding the execution of the Ostrołęka C Project, i.e. preparation, construction and operation of a 1,000 MW class coal-fired power unit.

2. Assessment of the standing of the ENERGA Group

In 2016, ENERGA SA Group generated weaker results than last year. This resulted principally from recognition of impairment losses of non-financial non-current assets of the Generation Segment, in the amount of PLN 573 m, compared to PLN 17 m in 2015. Net profit amounted to PLN 147 m and was 83% lower than in 2015.

EBITDA earned by the Group in the amount of PLN 2,027 m was PLN 189 m, or 9%, lower than in the previous year.

The Distribution Segment had the highest contribution (85%) to the Group's EBITDA. This segment recorded an EBITDA higher by 2% compared to the previous year. This is attributable mainly to a decrease in operating expenses compensated by a decrease in the distribution tariff and lower revenues from connection charges. The Distribution Segment recorded also a better result on other operations.

The Generation Segment contributed 16% to the Group's EBITDA. Its EBITDA was PLN 77 m lower, which was caused by the lower revenues on sales of electricity and property rights, offset by lower fuel consumption expenses. The decrease in revenues on sales of electricity was dictated by the lower electricity sales prices in the Ostrołęka Power Plant and Hydro business lines and decrease in the level of energy production yoy.

The revenues on the sale of property rights resulted from entry into force of the new RES Act as of 1 January 2016, which suspended support for hydro power plants with the capacity exceeding 5 MW and reduced support for large biomass co-fired sources. Additionally, the market price of property rights fell (the weighted average OZEX_A index in 2015 was 124 PLN/MWh, compared to 74 PLN/MWh in the corresponding period of 2016). In addition, there was a delay in the sale of inventories of green property rights by the Segment, which due to the falling prices pushed EBITDA further down.

The contribution of the Sales Segment to the Group's EBITDA in 2016 was 2%. EBITDA decreased by PLN 133 m compared to the previous year mainly as a result of a lower unit margin on electricity sales which is a key component contributing to the Segment's performance. The lower margin is the result of lower average electricity sales prices to end users (-5% yoy) compared to the decrease of the average unit variable cost (-2% yoy) and the less advantageous structure of sales according to tariff groups.

In 2016, sales revenues in the ENERGA SA Group were PLN 10,181 m, down PLN 623 m compared to 2015. All segments recorded a decrease in revenues in 2016 - Distribution Segment (-3%), Generation Segment (-18%) and Sales Segment (-2%).

In 2016, the ENERGA Group incurred:

- 1) cost of sales of PLN 8,846 m, i.e. 1% more than in 2015;
- 2) selling and distribution expenses of PLN 338 m, i.e. 1% more than in 2015;
- 3) general and administrative expenses of PLN 318 m, i.e. 8% less than in 2015;
- 4) other operating expenses of PLN 309 m, i.e. 107% more than in 2015.

As at the end of 2016, total assets of the ENERGA Group reached PLN 18,731 m and were PLN 275 m (1%) higher than as at the end of 2015.

In non-current assets the most important change pertained to investments in joint ventures measured by the equity method (PLN 390 m), which is associated with the ENERGA Group's exposure in Polska Grupa Górnicza Sp. z o.o.

In the period under analysis, compared to end of 2015, current assets decreased by PLN 367 m (or 8%). The most significant changes concerned the following items in particular: cash down by PLN 198 m) and investments in the portfolio of financial assets (down by PLN 320 m), associated with disposal of the participation units in the ENERGA Trading Fund.

On the liabilities side, a significant change occurred in liabilities on account of loans and borrowings, which went up by PLN 742 m compared with December 2015 figures (or 28%), mainly due to the launch of financing from EBRD and EIB in 2016, in the total amount of PLN 936 m, partially offset by the repayment of the liabilities incurred in previous years. In addition a decrease in bonds issued (PLN 475 m, i.e. 15%) was recorded, resulting mainly from redemption of some of the bonds issued by ENERGA SA.

The ENERGA Group's equity as at 31 December 2016 was PLN 8,817 m. ENERGA SA's result for 2016 was allocated with PLN 571 m going to reserve capital, PLN 67 m to supplementary capital, and PLN 203 m being designated as a dividend payment to the Company's shareholders. The cash flow hedge reserve increased by PLN 35 m.

In 2016, the consolidated capital expenditures in the ENERGA Group were PLN 1,567 m, of which investments in the Distribution Segment consumed the most i.e. PLN 1,263 m. They comprised grid expansion to connect new customers and generators, as well as modernization aimed at improving the reliability of electricity supply. Expenditures were also made for innovative grid technologies and solutions. In the Generation Segment, the main works associated with the general overhaul of unit no. 3 in Ostrołęka B Power Plant and adaptation of the facility to environmental standards were completed.

In addition, construction of the Parsówek Wind Farm with the capacity of 26 MW was settled.

3. Assessment of the internal control system and the key risk management system

The Company has an internal audit unit (Audit Department) which carries out the audit and control tasks in ENERGA SA and coordinates audit activities in ENERGA SA Group Companies, comprising in particular:

- 1) methodological support,
- 2) preparation and update of regulations and documents in the area of audit,
- 3) development of an audit plan for the ENERGA Group,
- 4) preparation of annual reports on the activity of internal audit in the ENERGA Group.

The Audit Department helps the organization maintain effective and efficient control mechanisms through promotion of their constant improvements and their assessment, while following International Standards for the Professional Practice of Internal Auditing No. 2130 – Control.

The scope of powers and responsibilities of internal audit in the ENERGA Group has been defined in the document entitled "Rules for conducting audit in the ENERGA Group, edition IV" together with the document entitled „Audit Card of the ENERGA Group”. This

scope comprises coordination, conduct of audits and consulting provided by audit units in the ENERGA Group and may pertain to all areas of operations, taking into account applicable provisions of law. Having the audit card in the organization is of key importance for internal audit management; thanks to it internal audit activities are conducted on the basis of International Standards for the Professional Practice of Internal Auditing.

Supervisory Board members participating in the work of the Audit Committee remain in permanent contact with the Director of the Audit Department, receive current information on the audit activities conducted, reports on completed audits, as well as annual reports on the activity of the internal audit unit.

In 2016, an assessment of the internal control was performed with the participation of an external consultant (PricewaterhouseCoopers Sp. z o.o.). The assessment was conducted based on the COSO model covering the following areas:

- 1) internal control environment,
- 2) risk management,
- 3) selected control activities and actions,
- 4) information and communication,
- 5) monitoring and supervision.

The assessment was carried out using the IT tool for cross-section review of the internal control system at the Company level and identification of the areas for improvement of internal control. Thanks to this tool it was also possible to compare the results of the exercise to the results from previous years.

The assessment of the internal control environment was lower than in the previous year. This was related mainly to deterioration of selected elements of the Organizational Management Practices area. Despite introduction of the Change Management System, the rules contained therein have not been adopted as an official policy. In addition, due to organizational changes, no succession plans for 2016 were approved.

As part of the assessment of the internal control system carried out in 2016 by an external advisor in cooperation with the Audit Department, certain positive aspects of the actions taken by the Company were observed, i.e.:

- 1) involvement of the Management Board in managing the organization and making decisions of key importance for the Company through the practice of regular meetings;
- 2) supervision exercised by the Supervisory Board and Audit Committee. These bodies were involved, among others, in assessment of the strategic and medium-term, plans, financial standing of the company and Group, market situation, competitive position and internal environment. They also cooperated with the statutory auditor during the audit of the financial statements;
- 3) establishing an Ethics Council and implementation of rules of conduct in the form of the Code of Ethics, documents entitled "Policy for Counteracting Mobbing and Discrimination" and "Policy for Counteracting Abuse" in the ENERGA Group, together with communication channels available to the employees of the Group companies;
- 4) compliance with the rules associated with the granting, registration and withdrawal of powers of attorney, limits of powers and authorizations in force in the Company and formal definition of the scope of activities for each job.

As regards the selected control activities and activities, the assessment is similar to that from last year. Deterioration of the assessment in the area of the policies and procedures is caused by the fact that the Company has not formally adopted the project management methodology. Compared to 2015, one can observe improvement in the area of Security - this results from completion of the process of implementation of the Information Security Principles.

In the area of information and communication the Company maintains the high assessments from last year. A deterioration was recorded only in the area of acquisition and flow of information - this results mainly from lack of an annual, comprehensive survey of employee opinions.

In the area of periodic monitoring and assessments, the decrease in the assessment is associated with lack of consistency between the Company's internal documents. The inconsistencies occurred as the amendments in the Organizational Bylaws have not entailed changes to the Company's Organizational Governance.

Within the framework of the Internal Control System Assessment, among others the following recommendations were made:

1) adoption of the change management and program and project management methodology.

The methodology should support identification of the dependencies between the projects and programs and threats to their execution;

2) strengthening project management through identification of project types executed in ENERGA SA and Group Companies, analysis of available methodologies and making decisions on selection of the project management methodology and its implementation, supported by appropriate training for the management and employees;

3) continuation of the actions taken to implement a consistent IT strategy for the ENERGA Group;

4) considering the viability and benefits of introduction of a centralized compliance and compliance risk management function;

5) updating the business continuity plans after organizational or personal changes in the Company, and specifying the substantive unit responsible for their regular review and testing;

6) specifying, in the Company's Organizational Bylaws, the substantive owner as regards reporting of abuses;

7) undertaking cooperation by the System and IT Management Department with the Strategy and Strategic Assets Management Department in defining and updating strategic objectives and identifying possible risks related to non-performance;

8) taking actions which will significantly contribute to improvement of the functioning of the risk management system;

9) review of the risk identification and assessment methodology in the Company;

10) analyzing the possibility of concentration of the assurance functions in the Audit Department and developing a joint work methodology;

11) continuation of the actions taken by the Audit Department to propagate good internal audit practices in the Energa Group, standardization of the audit process and knowledge sharing;

12) carrying out an analysis of the needs and benefits of implementation of a GRC tool dedicated to support the risk management process, internal audit and compliance.

As part of the assessment of the risk management system carried out in 2016 by an external advisor in cooperation with the Audit Department, best practice areas were observed, such as:

- 1) existence of the Integrated Risk Management System formal framework, including the Risk Management Policy in the ENERGA Group and the Risk Management Methodology in the ENERGA Group approved by the Company's Management Board. These documents govern the risk management process in a manner close to the best practices in this area;
- 2) the Management Board's involvement in approving the risk assessment results and key risk management strategy;
- 3) the activities of the Financial Risk Management Committee comprising setting exposure limits for market risks, including FX and interest rate risks and liquidity limits.

In 2016, a slight deterioration was observed in the Risk Management area compared to the previous year. This is related to absence of testing of the impact of the set risk appetite on the Company's financial results, business model, liquidity and solvency, lack of formally adopted results of the second risk identification review (which resulted from organizational changes) and incomplete presentation of the risk assessment measures. Actions have been identified that will significantly contribute to improvement of the functioning of the risk management system.

It was recommended that the role of internal audit be defined more precisely in the process of assessment of the effectiveness of implementation of risk management plans, decision be made on retaining the Risk Committee in internal regulations, a detailed process for carrying out in-depth analyses for key risks be defined, consistent risk controlling be maintained, and response plans in the event of their materialization be prepared and tested.

The risk appetite setting methodology does not provide for testing the impact of the set levels on the Company's results, business model, liquidity and solvency. In addition, the risk assessment methodology does not sufficiently take into account rare events of catastrophic effects. The approach used by ENERGA SA deviates from the reviewed approach applied by big corporations across the world. Hence it is recommended that the so-called reversed stress tests be carried out and the general immunity of the organization to external shocks be assessed more carefully. It is proposed to analyze the possibility of using a Long-Term Financial Model for the needs of such analyses.

Considering the above comments, which do not have material impact on the overall assessment, in the Supervisory Board's opinion, the internal control system in the Company is adequate and correctly organized. The Company takes actions to identify the existing risks and effectively plan and implement control actions. The correctness of the functioning of the internal control system is verified and assessed by the Audit Department.

The Supervisory Board evaluates the risk management system based on international experience and best practices of listed companies being implemented and its effectiveness as positive.

Date of the report: 29 May 2017

Signatures of the attending Supervisory Board Members:

CHAIRWOMAN	Paula Ziemiecka-Księżak
DEPUTY CHAIRMAN	Zbigniew Wtulich
SECRETARY	Agnieszka Terlikowska-Kulesza
MEMBER	Marek Szczepaniec
MEMBER	Maciej Żółtkiewicz