



LOTOS Group  
Integrated Annual Report 2016

02

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## OUR BUSINESS

Our business > Oil market in 2016

## Oil market in 2016

Since supply and demand for petroleum products are strongly correlated to economic and political developments in the world, the oil market in 2016 was highly volatile. As a result, in Q1 oil prices hit their 10-year lows, falling below **USD 30 per barrel**. The price level was difficult to predict due to such factors as periodic supply and demand imbalances, conflicts in African countries (Libya, Nigeria), and the **growing number of production wells in the US**.

Last year saw **expansion of the global market for refined petroleum products**. According to forecasts continued economic growth, especially in the CEE countries, will drive global demand for refining products in the coming years.

> In total, global demand rose **1.4%** across almost all refined petroleum product categories.

In 2016, demand for gasoline, diesel oil, and LPG for road transport applications went up 2.1%, 0.1%, and 5.7% year on year, respectively. Consumption of JET aviation fuel also increased, by 3%.

## Key drivers of the global market environment

### OPEC output quotas

The continuing downward trend in crude oil prices was a source of major concern for most of the market players such as OPEC countries or Russia, whose budgets rely heavily on oil revenue. Having acknowledged the gravity of the problem, those countries took steps to halt the trend.

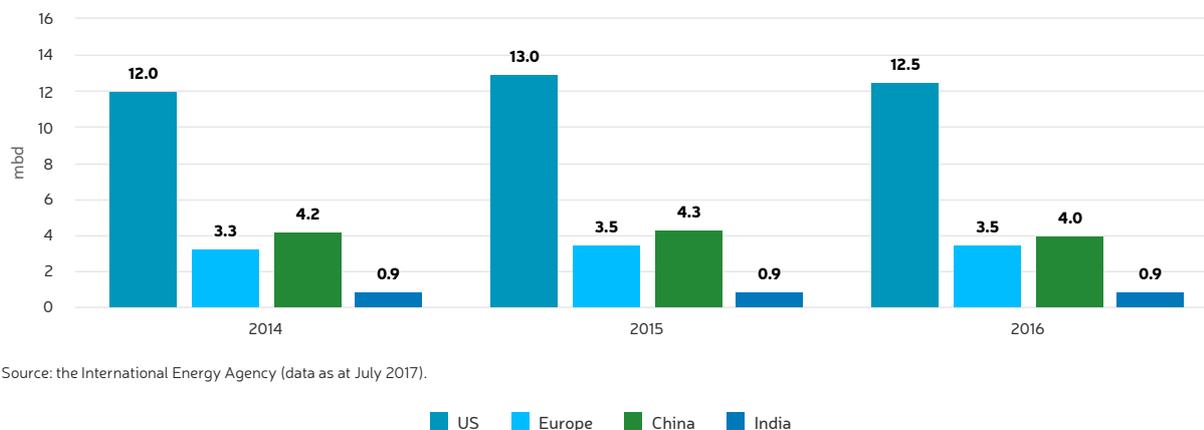
### Rising production from shale gas deposits in the US

Globally, oil price growth is mainly tempered by rising production from shale gas deposits in the US, which is increasingly profitable due to reduced costs and technological progress. Unconventional production is also gaining popularity beyond the US.

Despite a decline in crude oil prices, production has remained high in the US since 2015. In Brazil, oil production from pre-salt reserves (5–7 km under the seabed) reached record levels in January 2017, and all indications are that there will be more oil from this source.

> Accumulating stocks of crude oil across the world, especially in the US, also put a damper on oil prices. Stocks of oil in the US have reached their highest level in the last 30 years, at 520m barrels.

Crude oil production in the US, Europe, China and India



## Europe – demand up 2.2%

The economic upturn in the European Union and in the eurozone seen in 2016 led to increased demand for refined petroleum products, both aviation and automotive fuels. It is estimated that the aggregate demand for those products went up 2.2% on 2015. Consumption of JET aviation fuel, diesel oil, LPG, and light fuel oil rose 3.4%, 2.8%, 4.2%, and 0.9%, respectively. Lower demand was seen only in the case of gasoline (down 0.3%).

According to forecasts until 2022, the European market will grow, and total consumption of refined petroleum products is expected to go up by **1.3%**. This trend reversal has a significant impact on the Polish market.



In the period until 2020, a strong increase is expected in the EU's consumption of JET aviation fuel and diesel oil, of 11.9% and 3.8%, respectively. According to forecasts, demand for gasoline will decline markedly, by as much as 11.0%.

In 2016, the motor vehicles market in the European Union grew 7.4% compared with 2015. The number of new cars exceeded 20 million. The number of new cars registered in the EU rose 4.5% in 2016, with the total number of new registrations coming close to 15 million. The number of lorries also increased, by 11.7%, and new registrations in this category totalled more than 2.3 million.

At the same time, however, new solutions are being consistently launched on the market to reduce the consumption of conventional fuels, electromobility and alternative fuels being cases in point. The last decades were also a period of deep demographic changes (ageing population) and progressing evolution of consumer habits, leading to fewer consumers in the future. In consequence, demand for gasoline is expected to significantly decline in the EU by 2022 (down 11.0%).

## Polish fuel market – the Fuels Package boosts official fuel consumption

In 2016, Poland's GDP was up 2.7%<sup>1</sup>, driven by uptrends in manufacturing and construction. The unemployment rate at the end of 2016 was one of the lowest on record, at 8.3%<sup>2</sup>. As a result, consumption rose across all product categories, including in the fuel market.

2016 was also the third consecutive year to see growth in official fuel consumption in Poland. It went up 13%, including: 15.5% for diesel oil, 7% for gasoline, and 1% (roughly on a par with the previous year) for light fuel oil.

Efforts to counteract the grey market in Poland, undertaken both by the government (the Fuels Package) and legitimate fuel suppliers, have reduced the market's size, additionally contributing to an increase in registered demand for diesel oil.

<sup>1</sup> Source: Central Statistical Office of Poland (GUS).

<sup>2</sup> Source: Central Statistical Office of Poland (GUS).



In the period from August to December 2016, official consumption grew **20.1%**, beating even the most optimistic of analyst forecasts. During that period **diesel oil** consumption rose the most, by 25.4%, which led to a 133% increase in diesel oil imports year on year.

To compare, **from January to July 2016** fuel consumption grew 7%, including diesel oil up 8% and gasoline up 5.6%.

Polish companies are leaders on the domestic retail fuel market (gasoline, diesel oil, and LPG) – their market share in 2016 was 33.1% (down 0.6 pp year on year). The share of international companies was also down (0.3 pp year on year), to 21.6%.

In 2016, the market for LPG (a substitute of gasoline) grew 8%, to 2,535 thousand tonnes. The LPG market in Poland may be described as mature, with annual consumption volumes at 2,200–2,300 thousand tonnes in each of the last five years. Consumption of aviation fuel in 2016 rose 11% on the back of the growing number of airline services, expansion of new airlines and a steady increase in the number of passengers.

Our business > The LOTOS Group – stability amid a volatile market environment

## The LOTOS Group – stability amid a volatile market environment

- The LOTOS Group is committed to ensuring continuity of crude oil supplies at optimum prices and diversifying the supply sources.
- In 2016, the LOTOS Group reported higher sales of its products: they grew 6%, including 9% in the domestic market and 2% internationally.
- The LOTOS Group's strong performance was supported by the Fuels Package, whose introduction on August 1st 2016 boosted official fuel consumption in Poland by 20.1% in the period between August and December 2016 and 13% year on year.
- The LOTOS Group takes into account forecasts and megatrends which affect its business, including a global rise in consumption of aviation fuel and drop in consumption of gasoline by 2020.

## Diversification of supply sources

The LOTOS Group is committed to diversifying its supply sources in order to ensure energy security for Poland. Our specialists do not look for the types of crude oil similar to those delivered from the neighbouring countries east of Poland, but those which yield more interesting products. Moreover, completion of the EFRA (Effective Refining) Project will further expand the range of crude types used at the refinery.

In the first half of 2016, every fifth barrel of oil (21%) processed by the LOTOS refinery was imported from sources other than countries east of Poland, while in the first quarter of 2017 it was almost every third barrel of oil (32%). This came as a result of our continuous efforts to ensure greater diversification of supply sources of raw materials strategic for the economy and to increase Poland's energy security.

### More information

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

Chapter 4.4.3. Procurement and supply

## New markets

LOTOS Oil signed an agreement with Oupul Oil & Gas Group of China, and thus the LOTOS Group entered the largest market in the world. As much as 17,000 tonnes of premium quality lubricating (engine and industrial) oils manufactured by LOTOS Oil will be sold each year to Chinese customers in the next six years. Oupul Oil & Gas Group has declared its interest in a strategic and long-term cooperation with the LOTOS Group.

## Sound performance of the LOTOS Group in Poland

Increased demand for refined petroleum products, mainly diesel oil and gasoline, in Poland and abroad drove up the LOTOS Group's sales of products to 11.9m tonnes in 2016, up 6% year on year, including 9% domestically and 2% internationally.

### **More information**

[\*Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016\*](#)

Chapter 3. Macroeconomic environment of Grupa LOTOS S.A. and the LOTOS Group in 2016

Our business > The LOTOS Group – stability amid a volatile market environment > Our performance – discussion of the LOTOS Group’s financial position

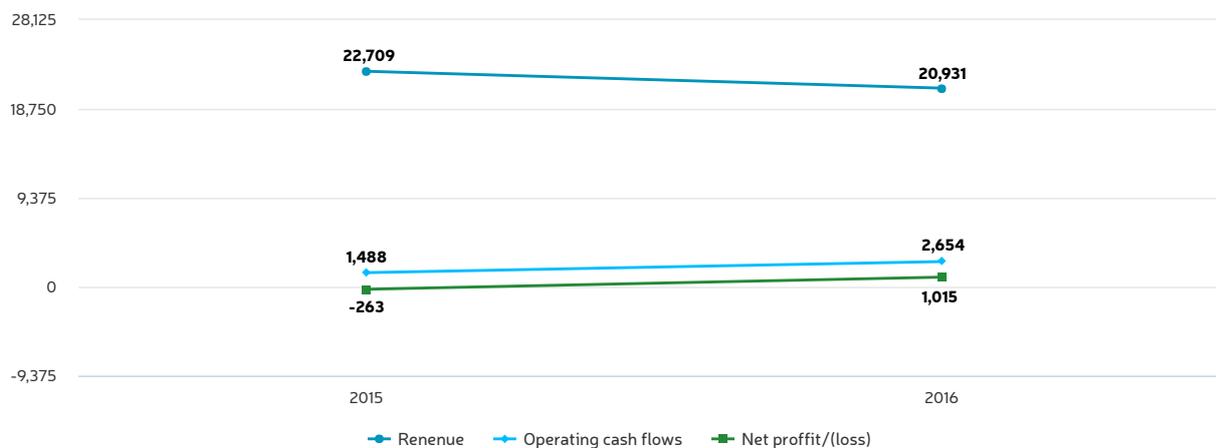
## Our performance – discussion of the LOTOS Group’s financial position

[G4-EC1] [G4-9]

- In 2016, the LOTOS Group improved its operating performance again.
- Consolidated revenue amounted to PLN 20.9bn.
- Adjusted LIFO-based EBITDA was at a record high, at PLN 2.59bn.
- The LOTOS Group’s consolidated net profit was the highest on record and exceeded PLN 1bn.
- The LOTOS Group’s debt was reduced by a healthy PLN 4.8bn net.

At the LOTOS Group, we consistently strive to increase operational efficiency, which, coupled with the favourable macro environment in 2016, contributed to the LOTOS Group’s sound operating performance.

### Strong financial performance, particularly cash flows

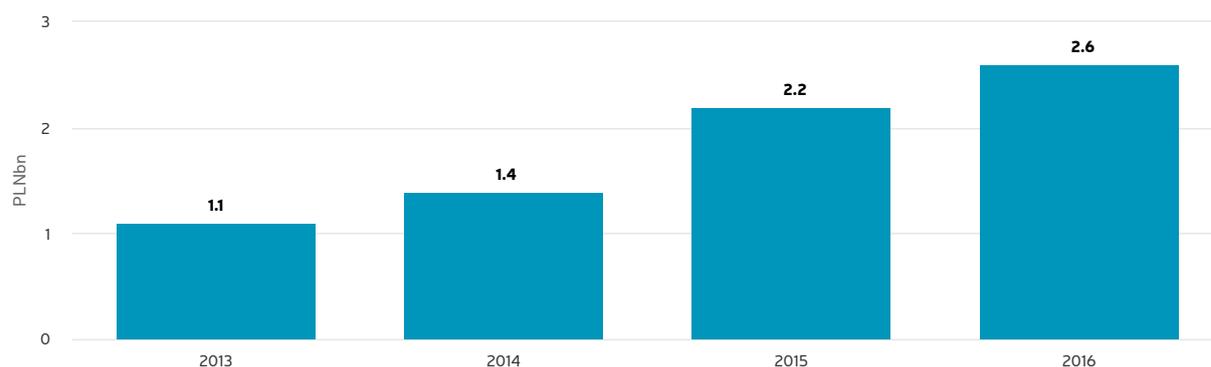


In 2016, the LOTOS Group **improved its operating performance again**. Consolidated revenue was **PLN 20,931m**. Adjusted LIFO-based EBITDA was at a record high at **PLN 2.59bn**. In 2016, the LOTOS Group earned a consolidated net profit of **PLN 1,015m**.

### Record-high LIFO-based EBITDA

In 2012–2015, adjusted LIFO-based EBITDA averaged PLN 1.67bn, while in 2015 it grew to PLN 2.16bn and in 2016 to a record high of **PLN 2.59bn**. This continued growth of EBITDA lends credibility to the LOTOS Group’s objectives outlined in the new business strategy for 2017–2022: the target for 2018–2019 is average annual LIFO-based EBITDA of PLN 2.2–2.6bn, and we plan to increase it in 2020–2022 to **PLN 3.8–4.4bn**.

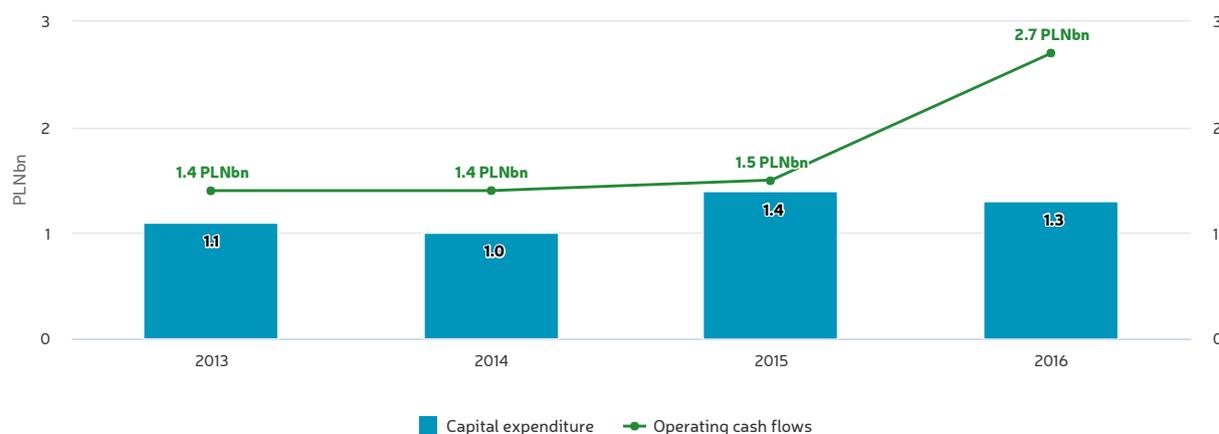
### LIFO-based EBITDA



### Strong operating cash flows

The LOTOS Group generated positive cash flows from operating activities of **PLN 2,653.9m** (up PLN 1,165.9m on 2015), mainly on net profit before depreciation and amortisation, income tax, and higher trade payables, which were offset by lower trade receivables. High-quality assets generate operating cash flows which are then used to finance business development projects.

### Operating cash flows and capex



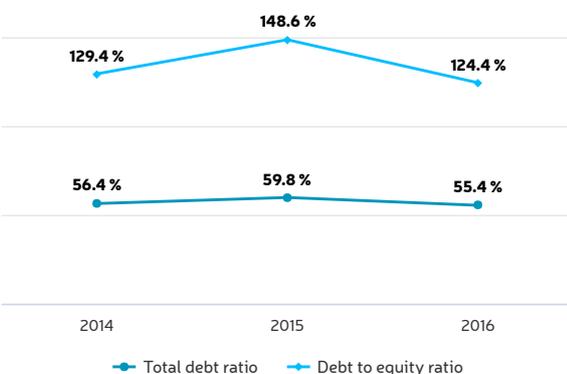
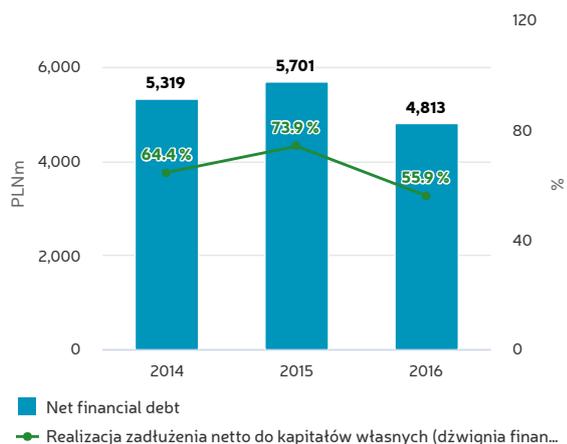
### Revenue

In 2016, the LOTOS Group posted **PLN 20,931.1m** in revenue (down 7.8% on 2015), driven mainly by lower prices of crude oil and petroleum products on global markets. Average net revenue **per tonne/(toe) of products sold in 2016 was PLN 1,761** (down PLN 261, or 12.9%, on 2015). The total volume of petroleum products, merchandise and materials sold in 2016 by the LOTOS Group increased by approximately 6% on 2015.

### Debt reduction

In 2016, we managed to reduce our debt to a level that will give us more comfort with implementing our strategic objectives, i.e. to **PLN 4.8bn**.

Capital structure and debt ratios (PLNm or %)



Debt fell as a result of:

- Decrease of 4.3pp in the share of liabilities in the financing of assets, as liabilities went down by 6.5% and assets grew by 0.8%,
- Decrease of 18.0pp in net debt to equity ratio (financial leverage), as net financial debt fell by 15.6% while equity grew by 11.7%,
- Decrease of 24.1pp in debt to equity ratio, as liabilities fell by 6.5% and equity went up by 11.7%.

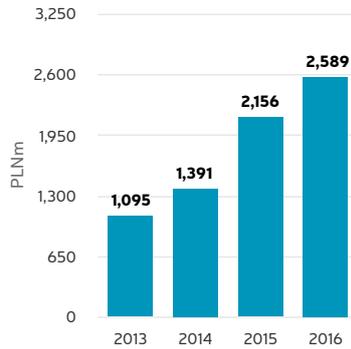
**More information**

*Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016*

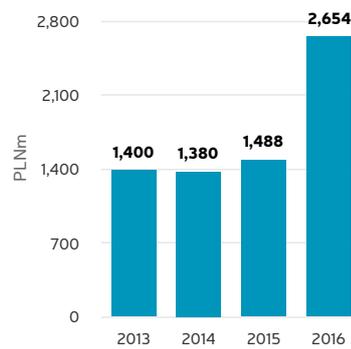
Chapter 5.3. Financing

## Grupa LOTOS shares on the Warsaw Stock Exchange

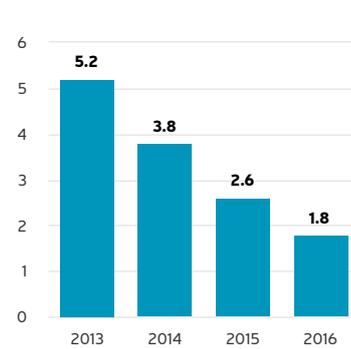
Adjusted LIFO-based EBITDA



Operating cash flow



Net debt to adjusted LIFO-based EBITDA



**More information**

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

Chapter 5. Financial standing of Grupa LOTOS S.A. and its Group

Grupa LOTOS shares have been listed on the Warsaw Stock Exchange since June 2005, and are included in the WIG20 index of WSE's 20 blue chips, the WIG-Paliwa index of the fuel market, and the RESPECT Index of socially-responsible companies.

## Grupa LOTOS stock performance since IPO

Grupa LOTOS share price (PLN) and trading volume (number of shares)



## Factors affecting the price, including key events at Grupa LOTOS:

In 2016, the situation on capital markets, including in Poland, was largely affected by global economic developments. The most important events were:

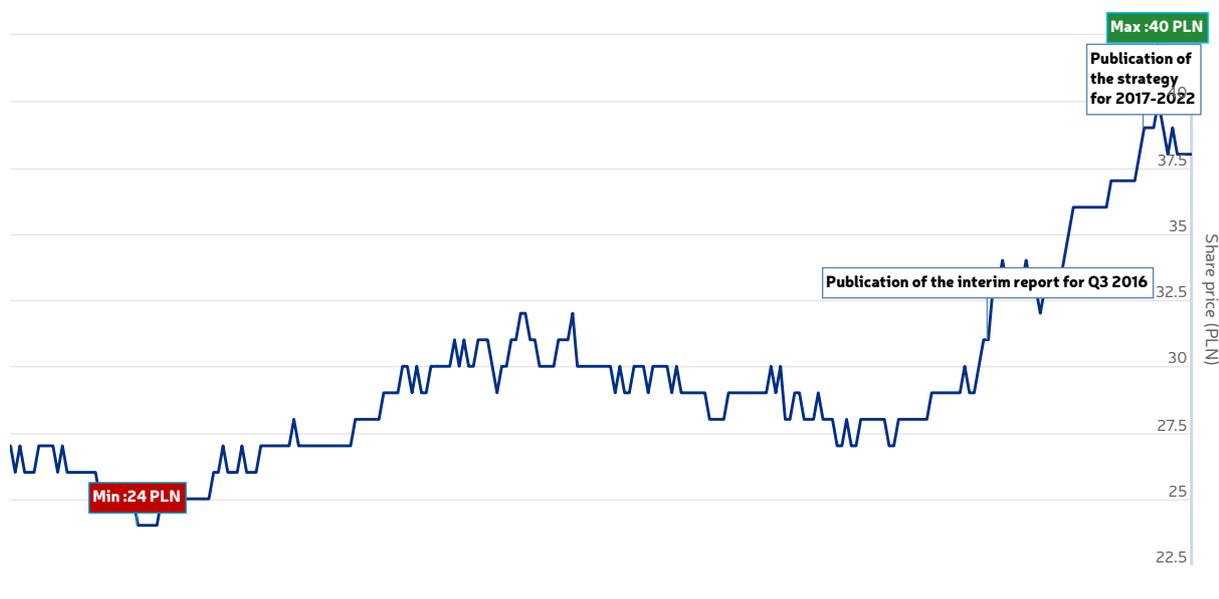
- Brexit and uncertainty about the scale of its consequences,

- Concerns about the future of open-ended pension funds,
- Reduction of the grey market for fuels through new regulations,
- No final decision on the conversion of CHF-denominated loans.

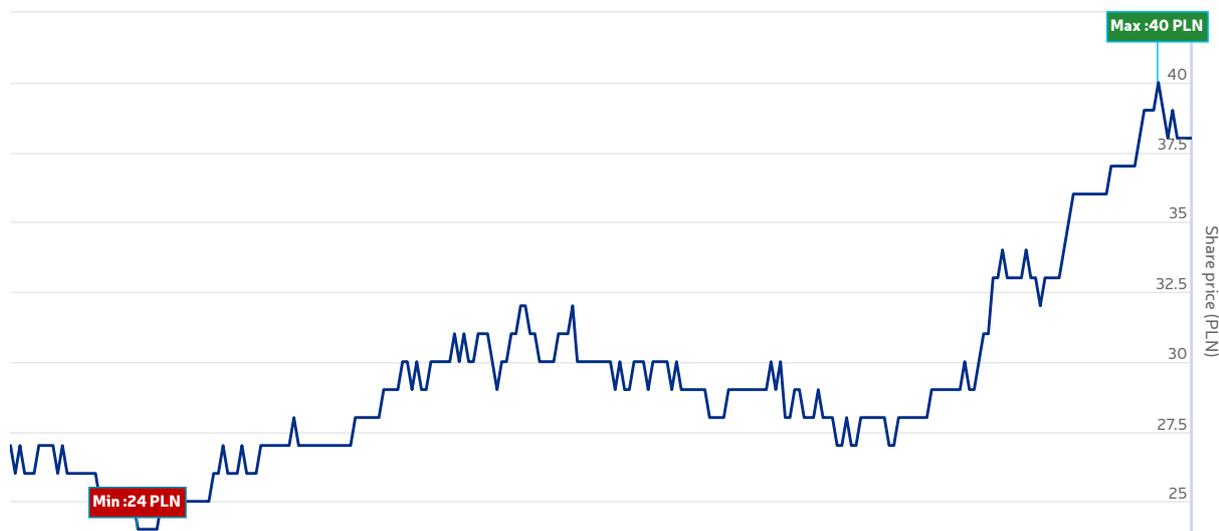
The combination of those factors drove the situation on the Warsaw Stock Exchange. For most of the year, the WSE's main index (WIG) maintained a slight (single digit) growth, to accelerate only at its end. Over the full twelve months of 2016 WIG rose **14%**.

In 2016, Grupa LOTOS traded in the range **from PLN 24.10 to PLN 40.40** (2015: from PLN 22.90 to PLN 33.50), and the year's closing price was **PLN 38.25**, compared with PLN 27 in 2015. Over the whole of 2016, the price went up **46%**.

The price of Grupa LOTOS shares increased in response to information on the **financial performance for Q3 2016**, announced towards the end of October, when the Company's EBIT proved better than expected. This improvement was supported by the effects of new regulations which **helped curb the grey market for fuels**, to the advantage of Grupa LOTOS. The publication of the LOTOS Group's **new business strategy for 2017–2022** on December 15th 2016 was well received by investors, pushing up the share price during the last two weeks of 2016.



Grupa LOTOS share price in 2016



## Structure of broker recommendations on Grupa LOTOS shares in 2016

The target price of Grupa LOTOS shares in brokers' research reports fluctuated from PLN 24.00 to PLN 41.20, compared with PLN 22.90 to PLN 33.50 in 2015. The average target price in 2016 was PLN 31.26 (2015: PLN 30.47).

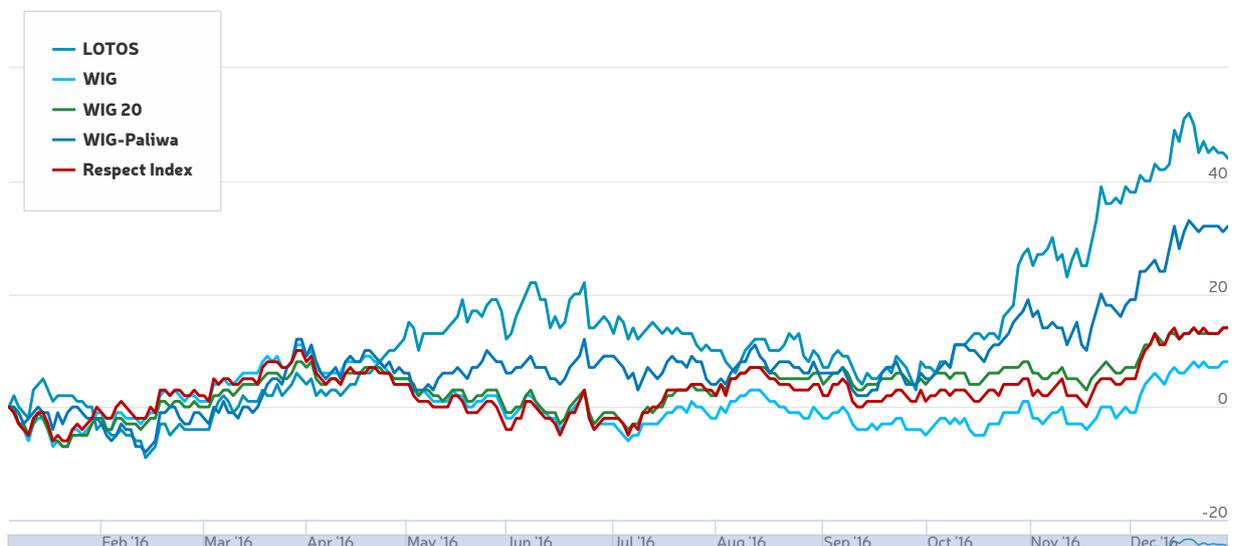
Brokers issued 12 recommendations on the Company shares in 2016:

- 4 BUY recommendations
- 3 ACCUMULATE recommendations
- 2 HOLD recommendations
- 2 NEUTRAL recommendations
- 1 SELL recommendation.

### Broker recommendations and moving average of target prices against the market price of Company shares



### Grupa LOTOS share price performance vs WIG, WIG20, WIG Paliwa and RE-SPECT Index [%]



In 2016, Grupa LOTOS outperformed the market as a whole.

#### More information

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

Chapter 8.1. Grupa LOTOS shares on the Warsaw Stock Exchange

## Dividends paid by Grupa LOTOS

One of the objectives of the Company's 2017–2022 strategy is to maintain dividend payment capacity.

In 2006–2016, the Company paid a dividend twice. The first distribution was for 2006 and totalled PLN 40,932 thousand, with dividend per share at PLN 0.4 and dividend yield of 0.7%. On June 14th 2017, the Annual General Meeting of Grupa LOTOS resolved to pay a dividend for 2016, in the amount of PLN 184,873.4 thousand. Dividend per share was PLN 1.0 and dividend yield was 2.61%.

### Dividend and dividend yield in 2005–2016

Financial year	Dividend (PLN)	Dividend per share (PLN)	Share price at the year end (PLN)	Dividend yield (%)
2005	0	0	44,2	-
2006	40,932,000	0,36	49,3	0,73
2007	0	0	44,5	-
2008	0	0	12	-
2009	0	0	31,8	-
2010	0	0	36,4	-
2011	0	0	23,3	-
2012	0	0	41,2	-
2013	0	0	35,3	-
2014	0	0	25,5	-
2015	0	0	27	-
2016	184,873,362	1	38.25	2,61

### Historical dividend per share (PLN)

Financial year	Dividend per share (PLN)	% of net profit	Dividend record date <sup>1</sup>	Dividend payment date <sup>2</sup>
2005	0	0.00	-	-
2006	0,36	10,06	Jun 11 2007	not later than Jul 31 2007
2007	0	0	-	-
2008	0	0	-	-
2009	0	0	-	-
2010	0	0	-	-
2011	0	0	-	-
2012	0	0	-	-
2013	0	0	-	-
2014	0	0	-	-
2015	0	0	-	-
2016	1	15.92	Sep 12 2017	Sep 29 2017

**More information**
*Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016*

Chapter 8.3, 8.4, 8.5

## Grupa LOTOS included in the index of socially-responsible companies for the 10th time

In 2016 again, for the 10th time, Grupa LOTOS shares became a constituent of the WSE's RESPECT Index – an index of responsible companies operating in accordance with exacting CSR standards in the areas of corporate governance, information policy and relations with investors, the environment, society and employees.

Grupa LOTOS has been present in the RESPECT Index since its inception in 2009. To date, the WSE has announced ten editions of the index. The most recent one, announced at the end of 2016, includes 25 companies. Since its first publication in 2009, the RESPECT index has increased by 50%.

## Comments

In 2016, cost of sales of the LOTOS Group stood at PLN 17,215.7m (down 15.0% on 2015). In the same period, the estimated unit cost of sales was PLN 1,448/t (down PLN 355/t or 19.7% on 2015). The unit sales margin in 2016 came at PLN 313/t (up 42.9% on 2015). The LOTOS Group's consolidated gross profit for 2016 was PLN 3,715.4m (up PLN 1,255.0m, or 51.0% on 2015).

Administrative expenses decreased by PLN 33.2m (down 7.5% on 2015) mainly on lower employee benefits expense.

In 2016, the LOTOS Group reported net other expenses of PLN -143.7m, including chiefly:

- PLN -61m in net impairment losses on exploration assets and non-current assets and revaluation of provisions related to production activities in the Baltic Sea (including PLN -65m in impairment losses on expenditure related to the Gaz Południe licence area),
- PLN -22m in net impairment losses on assets and remeasurement of provisions related to the Norwegian fields
- PLN -5m write-off of expenditure related to Lithuanian assets,
- PLN -12m in impairment losses on service stations.

The LOTOS Group's operating profit for 2016, **of PLN 1,854.7m (2015: PLN 423.4m)**, included:

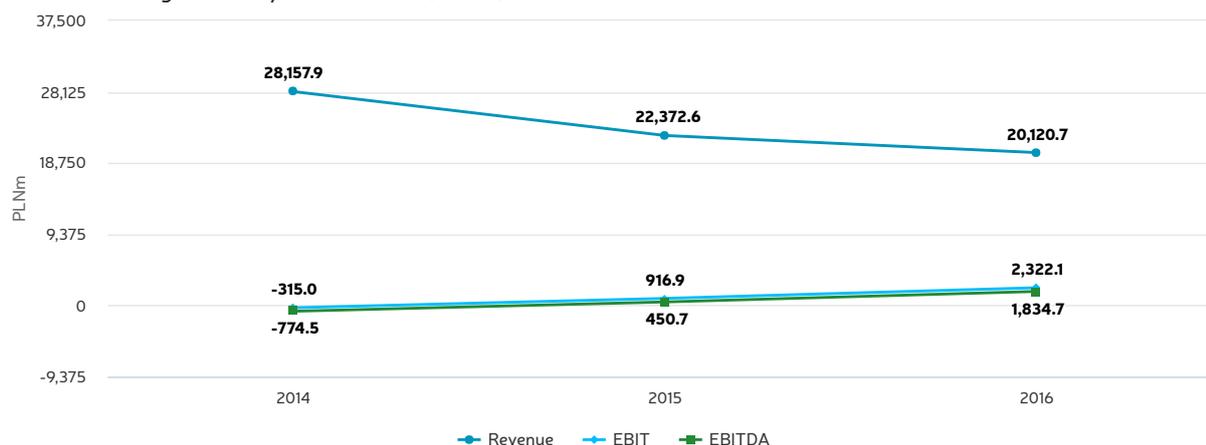
- Operating profit of PLN 1,834.7m in the Downstream segment,
- Operating profit of PLN 17.8m in the Upstream segment.

The 2016 increase in operating profit was driven mainly by the uptrend in crude oil and petroleum product prices vs the previous year's downtrend, the higher USD/PLN exchange rate in 2016, and the higher differential for the Urals crude.

### Upstream segment's key financial data (PLNm)



## Downstream segment's key financial data (PLNm)



The lower revenue posted by the Downstream segment in 2016 relative to 2015 was mainly due to a 10.9% fall in average selling prices caused by lower prices of oil products on global markets, offset by the higher USD/PLN exchange rate. In 2016, the LOTOS Group posted an operating profit of PLN 1,834.7m in the Downstream segment; the main contributors included rising prices, higher exchange rates, higher differential for the Urals crude, and lower cost of gas purchased by the refinery for its own needs.

## Cash flows (PLNm)

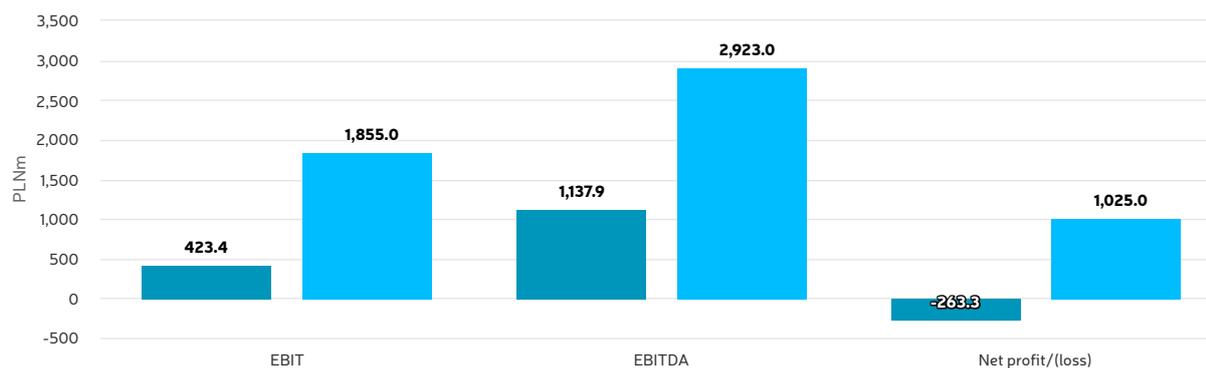
	2016	2015	change
Cash flows from operating activities	2 653.9	1 488.1	1 165.80
Cash flows from investing activities	-1 003.2	-1 162.0	158.8
Cash flows from financing activities	-1 201.4	114.7	-1 316.10
Change in net cash	452.7	444.8	7.9
Cash and cash equivalents at beginning of period	278.1	-166.7	444.8
Cash and cash equivalents at end of period	730.8	278.1	452.7

As at December 31st 2016, the LOTOS Group's cash balance (including current account overdrafts) was PLN 730.8m. In 2016, net cash flows added PLN 452.7m to cash and cash equivalents. The LOTOS Group generated positive cash flows from operating activities of PLN 2,653.9m (up PLN 1,165.9m on 2015), mainly on net profit before depreciation and amortisation, income tax, and higher trade payables, which were offset by lower trade receivables.

Cash flows from investing activities of PLN -1,003.2m primarily included expenditure on acquisition of property, plant and equipment and other intangible assets. A portion of expenditure on the EFRA Project in 2016 was financed with proceeds from the issue of Grupa LOTOS Series D shares deposited in a separate bank account.

Net cash flows from financing activities of PLN -1,201.4m were due mainly to repayments of borrowings and interest payments, offset by proceeds from borrowings and a gain on settlement of financial instruments.

## Profitability ratio (PLNm or %)



Our business > Ethics and corporate governance

## Ethics and corporate governance

[G4-34] [G4-38] [G4-39] [G4-56] [G4-57] [G4-58] [G4-LA12] [G4-S03] [G4-S04] [G4-S05]

- Corporate governance is a way to build the LOTOS Group's relations with investors and employees based on transparency and trust.
- 2016 saw the appointment of a new Ethics Officer, who has a ten year track record of working with the trade unions active at the LOTOS Group.
- The LOTOS Group was audited and received the Integrated Management System Certificate for the next three years.
- Grupa LOTOS follows the *Best Practice for WSE Listed Companies 2016*. In line with its information policy, the Company reports all instances of non-compliance on an ongoing basis.

[G4-S03] [G4-S05]

- No instance of corruption was reported at the LOTOS Group in 2016. No corruption risk assessment was performed.

## Corporate governance builds our credibility

### Corporate governance

The LOTOS Group is committed to high standards of corporate governance and takes care to ensure they correlate strongly with its corporate social responsibility objectives to build a partnership with stakeholders, from investors to employees. Corporate governance strengthens the credibility of Grupa LOTOS as a company listed on the Warsaw Stock Exchange, which thus enhances the competitive position of the entire LOTOS Group.

The key objectives of corporate governance at Grupa LOTOS are as follows:

- Transparency of operations – presentation of a precise and true image of the Company, its strategy and financial position,
- Building trust in relations with the stakeholders,
- Consistent shareholder value creation,
- Accessibility to and equal treatment of all investors.

From its first listing in June 2005, Grupa LOTOS pursued its information policy in line with most of the recommendations set out in the document *Best Practices for Public Companies*. From 2008, it followed the *Code of Best Practice for WSE Listed Companies* (as amended on October 19th 2011 and November 21st 2012). Since January 1st 2016, the Company has followed the revised *Best Practice for WSE Listed Companies 2016*.

#### More information

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

Chapter 9.3. Corporate governance principles applied by Grupa LOTOS S.A. in 2016

## Disclosure policy of Grupa LOTOS

The Company uses a variety of tools for communicating with investors, including mailing, newsletters, webcasts, participation in conferences for institutional and individual shareholders and brokers, conference calls, one-on-one meetings, open-house days for analysts and investors.

In addition, Grupa LOTOS operates an [an investor relations website](#) . This service, available in Polish and in English, is updated on an ongoing basis and designed to provide both domestic and foreign investors and analysts with equal access to information.

The reports are published on the EBI (Electronic Information Base) platform, as well as (in English and Polish) on the Company's investor relations website.

## The General Meeting of the LOTOS Group

The powers of the General Meeting cover a wide range of matters detailed in the *Articles of Association* of Grupa LOTOS. All matters to be submitted to the General Meeting are first presented for consideration to the Supervisory Board. The rules of attendance and voting at General Meetings are set forth in the *Rules of Procedure for General Meetings of Grupa LOTOS*, which also specify the procedures for convening and cancelling General Meetings, their proceedings, and holding elections to the Supervisory Board.

#### More information

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

Chapter 9.2.1. General Meeting of Grupa LOTOS S.A.

The *Articles of Association* and *Rules of Procedure for General Meetings* are available on our [website](#) .

#### More information

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

**Chapter 9.2.4. Rules for amending the Articles of Association of Grupa LOTOS S.A.**

[More on the activities of General Meetings](#), including adopted resolutions and shareholders' questions.



[G4-34] [G4-38] [G4-39]

## Corporate governance structure of Grupa LOTOS

### The Supervisory Board

The Supervisory Board exercises ongoing supervision over Grupa LOTOS' business in all areas of its activity. It performs its duties collectively, but may also set up ad hoc or standing committees to exercise supervision of specific areas. Standing committees of the Supervisory Board include the Audit Committee, Strategy and Development Committee, and Organisation and Management Committee. The Supervisory Board may also delegate its members to individually perform certain tasks or functions.

The procedures to be followed by the Supervisory Board of Grupa LOTOS are defined in the Company's [Articles of Association and Rules of Procedure for the Supervisory Board](#).

[G4-38]

### Composition of the Supervisory Board of Grupa LOTOS (9th term)

- Beata Kozłowska-Chyła – Chairwoman, [Full profile](#)

- Katarzyna Lewandowska – Deputy Chairwoman, [Full profile](#) 
- Agnieszka Szklarczyk-Mierzwa – Member, [Full profile](#) 
- Dariusz Figura – Member, [Full profile](#) 
- Mariusz Golecki – Member, [Full profile](#) 
- Piotr Ciach – Member, [Full profile](#) 
- Adam Lewandowski – Member, [Full profile](#) 

For details of the Supervisory Board composition as at December 31st 2016 and changes made to the Supervisory Board of the 9th term during the reporting period, see the [Directors' Report](#) on the operations of Grupa LOTOS in 2016.

[More information on the Supervisory Board of Grupa LOTOS](#) 

#### More information

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

Chapter 9.2.2. Supervisory Board of Grupa LOTOS S.A.

## The Board

The Board of Grupa LOTOS represents the Company before third parties and manages its corporate affairs. Members of the Board manage the respective areas of the Company's operations. Each member of the Board is authorised to represent the Company in court and out of court in relation to its business, with the exception of matters reserved for the General Meeting or the Supervisory Board under the *Commercial Companies Code* or the Company's *Articles of Association*, matters falling outside of the ordinary course of business where they require the Board's prior resolution, and matters within the powers of another member of the Board.

The Board operates on the basis of the Grupa LOTOS' [Articles of Association and its Rules of Procedure](#) .

[G4-34]

## Composition of the Board of Grupa LOTOS as at August 31st 2016

- Marcin Jastrzębski – President of the Board, [Full profile](#) 
- Mariusz Machajewski – Vice President, Chief Financial Officer,
- Mateusz Aleksander Bonca – Vice President, Chief Strategy and Development Officer, [Full profile](#) 
- Jarosław Kawula – Vice President, Chief Refining Officer. [Full profile](#) 

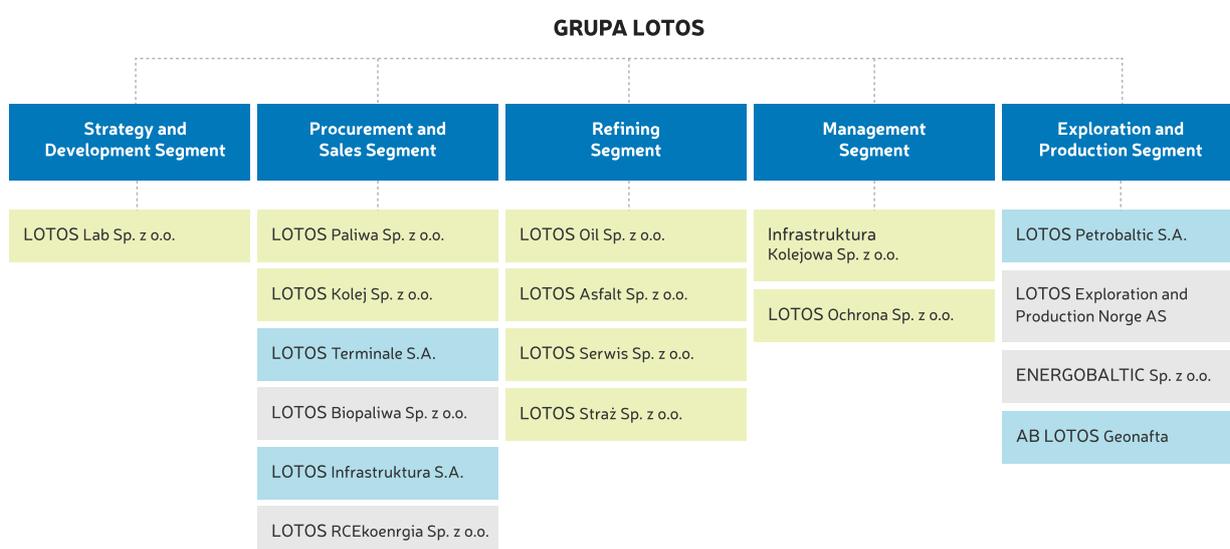
For details of the Board composition as at December 31st 2016 and its changes during the reporting period, see the [Directors' Report](#) on the operations of Grupa LOTOS in 2016 (Chapter 9.2.3. Management Board of Grupa LOTOS S.A. and powers of individual members).

## Management structure

As at December 31st 2016, the LOTOS Group comprised Grupa LOTOS S.A. as the Parent, and 35 production, trading, and service companies, including:

- 13 direct subsidiaries of Grupa LOTOS,
- 21 indirect subsidiaries of Grupa LOTOS,
- and one foundation.

Direct subsidiaries and selected indirect subsidiaries relevant to this report are attributed to the following management segments (as at June 2nd 2017):



**More information**

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

Chapter 1.2. Overview of the Group's organisation and management

## Integrated Management System

In 2016, a recertification audit was carried out at Grupa LOTOS to review its Integrated Management System (quality, environment and OHS). The audit demonstrated adequate specialist knowledge of the people working in the audited areas and their commitment to continuous improvement of the Integrated Management System (IMS) processes. As a result of the audit the Company maintained its IMS certification.

**Benefits from the IMS implementation:**

- Meeting the customers' and trading partners' requirements.

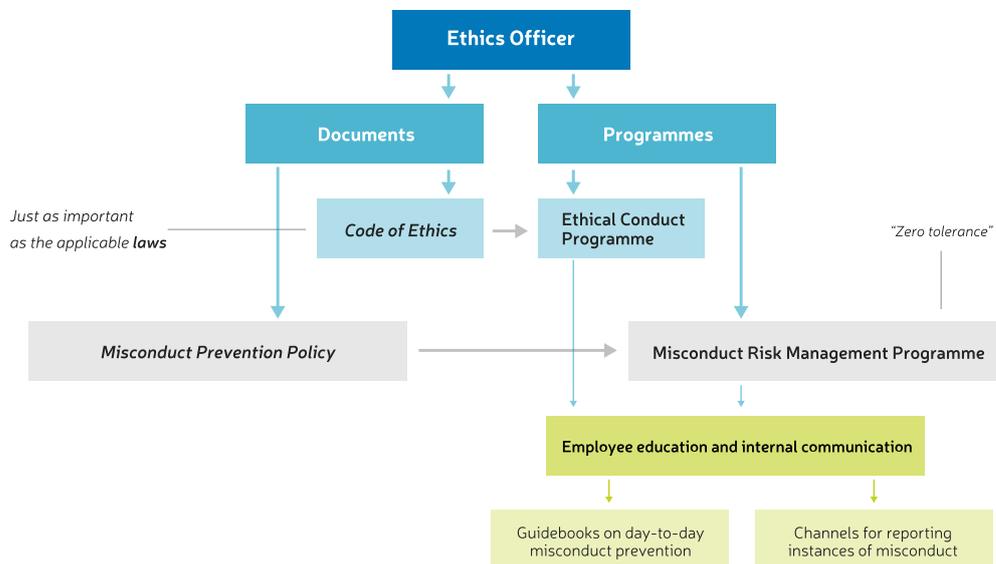
- Meeting the legal requirements.
- Enhancing the organisation's effectiveness and efficiency in attaining its strategic and operating objectives.
- Streamlining of the organisation's processes.
- Mitigating the risks inherent in the business and taking advantage of opportunities as they arise.
- Management efficiency improvement, streamlining of the organisation.
- Improved work organisation, clear definition of the employees' tasks, competencies and responsibilities.
- Standardisation and centralisation of activities in defined areas across the LOTOS Group.
- Identification of areas for improvement.
- Encouraging pro-environmental activities at the organisation.
- Work safety improvement.
- Openness to other standardised management systems.

### Management systems at the LOTOS Group as at December 31st 2016

Company name	Management systems in place
Grupa LOTOS	Implemented and certified Integrated Management System compliant with the ISO 9001, ISO 14001 and PN-N-18001 standards. Implemented requirements of AQAP 2110 (Allied Quality Assurance Publication) and requirements of the Internal Control System for trading in strategic materials (conforming with the PN-N-19001 standard).
LOTOS Asfalt	Implemented and certified Integrated Management System compliant with the ISO 9001, ISO 14001 and PN-N-18001 standards. Implemented and certified Site Production Control System.
LOTOS Kolej	Implemented and certified Integrated Management System compliant with the ISO 9001, ISO 14001, and PN-N-18001 standards; Railway Transport Security Management System (SMS) compliant with Directive 2004/49/EC and national regulations; Rail Vehicle Maintenance Management System (MMS) compliant with Directive 2004/49/EC and Regulation (EU) 445/2011; Quality in Welding Management System compliant with the DIN EN ISO 3834-2 (EN 729-2) and EN 15085-2 standards; and system of Maintaining Freight Cars in accordance with the VPI requirements. In 2015, LOTOS Kolej's Railway Transport Security Management System (SMS) received Safety Certificate - PART B, compliant with Directive 2004/49/EC and national regulations, enabling the company to carry out rail freight operations using German rail infrastructure. In 2016, LOTOS Kolej implemented and obtained certification of the GMP+ B4 system, so it can contract freight for transport and transport fodders and grains by rail in the GMP+ system.
LOTOS Lab	Implemented and certified Integrated Management System compliant with the ISO 9001, ISO 14001 and PN-N-18001 standards. Polish Centre for Accreditation certificate of compliance with the PN-EN ISO/IEC 17025:2005 standard.
LOTOS Ochrona	Implemented and certified Integrated Management System compliant with the ISO 9001, ISO 14001 and PN-N-18001 standards.
LOTOS Oil	Implemented and certified Quality Management System compliant with the ISO 9001 standard and with the Allied Quality Assurance Publication (AQAP) 2110. Implemented requirements of the ISO 14001 and PN-N-18001 standards.

Company name	Management systems in place
LOTOS Petrobaltic	Implemented and certified Integrated Management System compliant with the ISO 9001, ISO 14001 and PN-N-18001 standards. Implemented ISM Code (for compliance with the International Management Code for the Safe Operation of Ships and for Pollution Prevention) and ISPS Code (International Ship and Port Facility Security System).
LOTOS Serwis	Implemented and certified Integrated Management System compliant with the ISO 9001, ISO 14001 and PN-N-18001 standards. Implemented and certified requirements of Quality in Welding Management System, compliant with the PN-EN ISO 3834-2:2007 standard, covering the construction of metal structures and auxiliary elements, EXC1, EXC2, EXC3 class steel structures in accordance with the PN-EN ISO 1090-1:2009+A1:2012 IDT EN 1090-1:2009+A:2011 standard, covering the requirements for the competence of testing and calibration laboratories in accordance with the PN-EN ISO/IEC 17025:2005 standard, and covering the repair of explosion-proof electrical equipment in accordance with the PN-EN 60079-19:2011 standard.
LOTOS Straż	Implemented and certified Integrated Management System compliant with the ISO 9001, ISO 14001 and PN-N-18001 standards.
LOTOS Terminale	Implemented Integrated Management System compliant with the ISO 9001, ISO 14001 and PN-N-18001 standards.
LOTOS Paliwa	Implemented and certified Quality Management System compliant with the ISO 9001 standard. Implemented requirements of the ISO 14001 and PN-N-18001 standards.

## Business ethics system



In 2016, the LOTOS Group continued its efforts to build a corporate culture of ethics. The intention of the LOTOS Group as an organisation aware of its impact on the environment is to conduct its business with due respect for generally accepted social standards. This approach is pursued by:

- Implementing the **Ethical Conduct Programme** addressed to the employees and external stakeholders; the Programme is a real foundation for the corporate culture and management of the organisation.

- Enhancing business process security through the **Misconduct Risk Management Programme**, which supports effective misconduct risk management throughout the organisation.

ETHICAL CONDUCT PROGRAMME	MISCONDUCT RISK MANAGEMENT PROGRAMME
<p><b>OBJECTIVE:</b> Business ethics as the principal strategic standard of the organisation</p>	<p><b>OBJECTIVE:</b> Deliberate and active building of the organisation's immunity to misconduct</p>
<p><b>Programme components:</b></p> <ul style="list-style-type: none"> <li>■ Code of Ethics</li> <li>■ Ethics Officer</li> <li>■ Reporting channels</li> <li>■ Education</li> <li>■ Communication</li> </ul>	<p><b>Programme components:</b></p> <ul style="list-style-type: none"> <li>■ Misconduct Prevention Policy</li> <li>■ Assessment of the organisation's immunity to misconduct</li> <li>■ Identyfikacja ryzyka nadużycia w procesach</li> <li>■ Education</li> <li>■ Communication</li> </ul>

[G4-56]

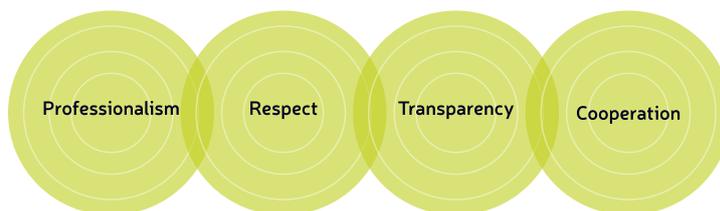
The Programmes are founded on two key documents: [the Code of Ethics](#) and [the Misconduct Prevention Policy](#).

[G4-56]

## Ethical Conduct Programme

The cornerstone of the Ethical Conduct Programme is the *Code of Ethics* and the values we chose to guide us in managing the organisation.

### Ethical values of the LOTOS Group:



The Ethical Conduct Programme is a bridge between the *Code of Ethics* and its implementation in everyday life and management of the organisation. With the Programme, we want to make business ethics a true ethical touchstone in managing the LOTOS Group.



[G4-57]

## New Ethics Officer

The duties of the dissolved Ethics Board that had operated for three years were taken over in mid-2016 by the Ethics Officer Paweł Pettke, who had been the LOTOS Group's Unions Officer for the previous ten years. The experiences of the former Ethics Officer attest to the great weight our employees attach to ethics. Meetings that address ethical issues attract large audiences. Several dozen ethics meetings were held in 2015 and 2016, attracting some **3,000 staff**. Over that time, the Ethics Officer received **more than 200 enquiries and advice requests**. In 2016, the Ethics Officer continued to interact with employees using proven direct communication channels, and received over 60 new enquiries. In line with the internal practice, the work of the Ethics Officer is performed without compensation.

[G4-57] [G4-58]

## Reporting misconduct

The Ethics Officer is available to all employees of the LOTOS Group and its trading partners. The following methods can be used to communicate with the Ethics Officer:

- A meeting in person at a time convenient to the employee, arranged in advance by phone,
- By phone or voicemail to the Ethics Officer (tel. no. +48 58 308 80 70)
- By email to: [liniaetyki@grupalotos.pl](mailto:liniaetyki@grupalotos.pl),
- Online report form available at [www.lotos.pl](http://www.lotos.pl),
- By regular mail.

## Zero tolerance for misconduct

The *Misconduct Prevention Policy* defines our strict approach as “**zero tolerance for criminal behaviour**”. By signing the *Code of Ethics*, our employees commit to behaving ethically and lawfully.

We support them through communication and education, showing them how to identify potential risks and prevent misconduct in everyday work. The *Guide* published by the Internal Audit Office serves this purpose. We also ran the 'Monday with Ethics' competition in 2016.

In addition, we have developed solutions that effectively prevent misconduct, as demonstrated by the results of periodic organisational maturity assessments.

[G4-58]

## Prevention of misconduct

- We have the Internal Audit Office in place as a body responsible for controlling the risk of misconduct.
- Employees and partners are trained in fraud detection and prevention.
- All suspected misconduct reports are kept confidential.
- We have a non-retaliation policy in place.

78 is the total number of unethical or illegal conduct reports submitted in 2016.

## Monday with Ethics

'Monday with Ethics' is an educational programme for all staff, promoting knowledge of the *Code of Ethics*. The competition asked employees to provide their interpretations of potential workplace misconduct scenarios in the light of the *Code of Ethics*.

The ethical dilemmas concerned the use of company property, dealing with conflicts of interest, and responding to unusual behaviour of a colleague or a discovered machine failure. The winners came from different LOTOS Group companies and organisational units.

[G4-57] [G4-58]

## The LOTOS Group's areas for development in ethics

### Setting up mechanisms for:

- Seeking advice outside the organisation/anonymously,
- Reporting concerns and instances of misconduct independently from the organisation (for example through a third party company).

### Implementing surveys to assess the level of satisfaction of those that:

- Requested ethical or legal advice,
- Used unethical or illegal conduct reporting mechanisms.

Our business > The LOTOS Group's external impacts along the entire supply chain

## The LOTOS Group's external impacts along the entire supply chain

[G4-12] [G4-EC9]

- We deliberately manage our impacts on the external environment along the entire supply chain.
- We work with partners who respect human rights and apply socially acceptable practices in the workplace.

### Supply chain ethics

Mindful of our external impacts and strong reliance on contractors and suppliers, we want to work with partners who also attach priority to the universally accepted system of values. This approach aims to ensure that our contractors and suppliers down the supply chain treat their own employees with respect and dignity.

**The LOTOS Group manages its supply chain by:**

- Coordinating purchases of raw materials and components,
- Planning production and raw material supply logistics,
- Production process,
- Distribution of products.

We uphold the philosophy of integrated supply chain management, whereby we seek to maximise the integrated economic effects of our operations while doing our best to meet the expectations of all stakeholders. The supply chain is an international environment where the LOTOS Group connects with its suppliers and customers.

- **Given the scale of our business, our network of relationships with suppliers and customers is a complex structure spanning various aspects, both at the operational level and the strategic level. When engaging in long-term business relationships, we pay attention to the market position and CSR record of our prospective partners. Many of our partners are international oil companies which have pioneered the industry's commitment to corporate social responsibility and business ethics.**

- As a vertically-integrated oil company, we take active steps to control the flow of raw materials, products, information, and financial resources within the organisation, from the moment a raw material is extracted, through production and distribution, to consumption of the final product by its end user.
- Aware of the importance of working with a local supplier base, we strive to partner with companies which offer the expected competencies and meet our standards of cooperation. We seek to minimise the negative impact of fossil fuels in transport by sourcing 72% of the components (bioethanol and FAME) we use to produce our fuels from local suppliers.
- We observe the highest quality and safety standards. Entities, including local businesses, which render services at our production facilities are provided with technical standards applicable to the work they are to perform, containing detailed information on the relevant technologies. Contractor employees undergo mandatory training, including in workplace safety. Our trading partners are invited to meetings at which they learn about the standards and values we adhere to and the rules of conduct applicable at the LOTOS Group.

## Key suppliers and customers

The following are the LOTOS Group's key suppliers, accounting for over 10% of total sales revenue in 2016:

- VITOL S.A. of Switzerland, with a 21.78% share in total purchases,
- Rosneft of Russia, with a 19.60% share,
- Tatneft-Europe AG of Switzerland, with a 14.53% share.

In 2016, none of the LOTOS Group's customers accounted for more than 10% of total revenue. In 2015, a customer accounting for more than 10% of total revenue was Statoil companies (with a total share of 10.04%).

The LOTOS Group had no formal links with its customers and suppliers other than commercial contracts.

## Building an ethical value chain

- **Supplier audits.** We define standards of conduct for suppliers, and we evaluate suppliers' compliance with the standards and track improvements.
- **Contract clauses.** We embed clauses in our contracts that require suppliers to comply with social responsibility standards and that govern the areas of labour rights, environmental protection and conflicts of interests.
- **Choice of socially responsible suppliers.**

**Best practice example.** Ambra. Ambra is a cleaning company that provides janitorial services in our office buildings in Gdańsk. Since 2014, it has been making efforts to integrate social commitment, local community engagement and environmental protection into its activities.

As part of its social commitment and local community engagement, the company hires people in the care of the local Municipal Family Welfare Centre, providing them with training and job stability under employment contracts. Mindful of the environment and client expectations, Ambra uses such solutions as dispensing cabinets to cut consumption of cleaning chemicals. This practice was acknowledged in the RBF's Responsible Business Report.

## World-class supply chain standards

The LOTOS Group develops its strategy of corporate social responsibility in the supply chain based on the methodology of the **Corporate Human Rights Benchmark** project. The initiative serves to draw the attention of global business to the violation of fundamental human rights by corporations, their contractors and suppliers. Its purpose is also to create a ranking of global listed companies and to recognise those that excel in human rights abuse prevention.

The Corporate Human Rights Benchmark methodology builds on internationally recognised standards, including the standards of business conduct in the area of human rights and child rights developed by the **UN**, and the **SA 8000** standard, which helps companies to develop, maintain and apply acceptable workplace practices. In addition, the methodology takes into account the **Sustainable Development Goals** in the 17 areas identified as key to further development of the world through wide-ranging public consultations.

## Risk management

[G4-2] [G4-14]

- Risk is inherent in our activities. It requires us to take particular responsibility for the environment and for the health and safety of our employees.
- In 2016, we carried out an internal review to evaluate the operation of our Enterprise Risk Management system.
- The primary sources of uncertainty affecting the achievement of our business objectives are strategic, financial, reputational and compliance risks.
- We operate a mature risk management system and have built a strong risk awareness culture.
- During 2016 we continued to deploy the RBI methodology, which allows us to comprehensively manage the risks of operating plant and equipment in the Gdańsk Refinery and extend maintenance intervals.

Our business > Risk management > Our approach to risk management

## Our approach to risk management

Every business decision that we make follows an analysis of the risks involved. The nature of the fuel industry demands that we take a strategic approach to mitigating risks affecting our organisation and its social environment. With applicable internal regulations and processes in place, we investigate and effectively mitigate potential threats on a daily basis.

At the LOTOS Group we take responsibility for our actions, therefore we have **adopted pro-active management of risks and opportunities as a strategic goal for 2017–2022, which we intend to pursue through the following initiatives:**

- First: we aim to build a strong culture of open dialogue and early response to risk symptoms,
- Second: we want our risk management framework to support processes that allow for stakeholder value creation.

Given our strong impact on the external environment, we take particular care to **investigate and identify risks** in all areas of our activity, including our flagship EFRA and B8 field development projects. Risk information is used in operational planning, budgeting and long-term forecasting. The LOTOS Group effectively mitigates risks inherent in its current operations by developing and refining policies and regulations governing its business processes, investment projects, and new product commercialisations.

Risk Management Model in LOTOS Capital Group assures risk governance through 3 lines of defence.

The first line of defence (1<sup>st</sup>) is based on operational functions that manage its own risks through process specific solutions, which are scaled adequately to risk dynamics and impact. Another, 2<sup>nd</sup> line consists of corporate functions that oversee and or specialize in risk management e.g.: Risk Management, Compliance and Finance. This level defines general rules, principles and criteria for risk management within LOTOS Capital Group as well as monitor an forecasting overall company risk exposure and risk profile. Eventually, adequacy and effectiveness of risk management system is verified periodically by Audit function (3<sup>rd</sup> Line of defence).

### ERM system

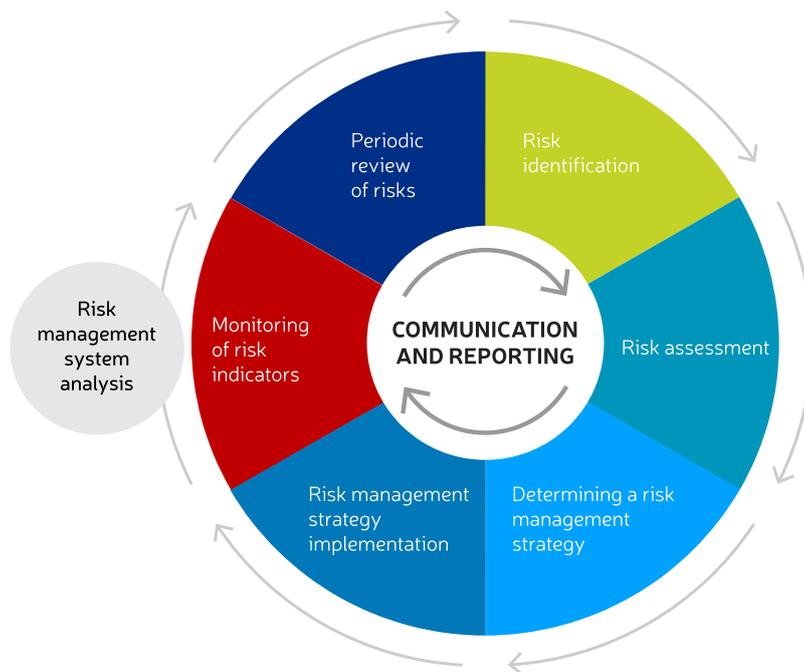
The comprehensive **Enterprise Risk Management (ERM) system**, in place at the LOTOS Group since 2011, was implemented to support safe operation of the organisation and achievement of its objectives.

Key responsibilities and general risk management guidelines are defined in the *Enterprise Risk Management Policy* developed by the LOTOS Group. Also, an Enterprise Risk Management Committee has been established at the Parent, which advises the Board on risk management.

### Risk management process

The key ERM tool is a risk management procedure, which describes the process and sets out the rules for risk identification, assessment, monitoring and reporting as well as methods designed to evaluate the effectiveness of mitigating actions taken.

In practice, risk management at the LOTOS Group is a multi-stage process comprising:



## Roles in the risk management process

**Supervisory Board** – monitors the effectiveness of the risk management system.

**The Board** – takes key decisions about the ERM system and identifies risk owners.

**Segment heads** – are responsible for overall monitoring and supervision of risk management in their segments.

**Enterprise Risk Management Committee** – provides opinions, recommends ERM-related actions and monitors their progress. The Committee consists of representatives of each segment.

**Risk Management Office** – coordinates and supports actions taken by risk owners.

**Risk owners** – manage individual risks, defining the course of action with respect to each risk and monitoring its levels.

**LOTOS Group employees** – implement risk mitigation activities and identify new risks.

**Internal Audit and Process Management Offices** – review and evaluate the effectiveness of implemented controls during internal audits, and identify and assess risks associated with the LOTOS Group’s operations. The Internal Audit Office annually evaluates the effectiveness of the risk management framework as part of the assessment of organisational maturity and individual risk management methods.

All of our risk management efforts are supported by an IT tool, **the ERM Portal**. The ERM Portal is used to record risks and risk assessment results and prepare risk maps, to monitor current risk indicators and the progress of planned actions, as well as for reporting purposes. Audit results are also recorded in the ERM Portal where the audit involves a review of the risk management procedures.

In 2016, we internally reviewed the operation of our risk management framework and developed future development directions in line with best market practices. **The LOTOS Group operates a mature risk management system and has built a strong risk awareness culture.**

## Key risks to our business

Key types of risk to the LOTOS Group’s business include operational, strategic, financial, reputational and compliance risks. They are the main source of uncertainty as to whether our operational and strategic goals will be achieved.



The volatility of the macroeconomic environment is a key variable determining the strategies of companies in the oil sector. For years, their business was based on long-term strategic plans. **However, what is crucial to success today is flexibility and the ability to respond swiftly to changes in the market. This is a challenge facing the LOTOS Group in the near future as, in order to expand, our business requires high capital expenditure with long investment project completion times, which consequently gives rise to uncertainty as to rates of return, i.e. creates risk.** Our analyses have revealed four groups of factors which have a material bearing on our business and pose the greatest risks. These are:

- Major changes in the mix of energy sources and environmental policy,
- Growing local and global competition,
- Accelerating advances in technology,
- Poland’s energy security.

Our business > Risk management > How we reduce the probability of risk materialising

## How we reduce the probability of risk materialising

Operating in a largely volatile macroeconomic environment, the LOTOS Group adopts a precautionary approach. Where possible, risk is reduced to a level considered economically acceptable.

### We give effect to this precautionary approach through:

- The ERM system, which supports the safe operation of our organisation and the achievement of business goals with due respect for our environment and its values.
- The *Code of Ethics*, which sets the standards of conduct in line with the LOTOS Group ethical values.
- Environmental protection and OHS standards, which ensure the highest standard of people's and process safety. With regard to HSE, we apply the ALARP (As Low As Reasonably Practicable) principle.
- Standardised contract forms, which lay down proper terms and conditions for cooperation with trading partners.
- Other policies and operating procedures, which define the acceptable risk levels in business processes.

#### More information

[Directors' Report on the operations of Grupa LOTOS S.A. and the LOTOS Group in 2016](#)

Chapter 6. Grupa LOTOS S.A.'s and the LOTOS Group's business risks

[Note 28. Objectives and policies of financial risk management](#) in Consolidated Financial Statements for 2016