

Grupa LOTOS operates in an environment and under conditions which carry a number of risks. These risks are identified and evaluated in various areas of activity and constitute a basis for decisions on further activities. Compared to the previous reporting period, the operational, financial and market risks have not changed considerably, being still present and continuously monitored.

Risks related to governmental strategy in the petroleum sector. Legal risks of strategic nature.

As part of its strategic analyses, Grupa LOTOS continuously monitors the policy directions pursued by the European Union. An examination of the draft directives and then the proper directives allows the Company to learn about the potential legal environment years in advance, before the transposition of Community solutions to the Polish law.

Grupa LOTOS co-operates with state administrative bodies responsible for governmental strategies in the petroleum sector. In addition, the Company participates in providing opinions on drafts of domestic legal acts and governing legal acts in the area of interest to the Company, in particular the provisions on oil and fuel mandatory reserves, biocomponents and biofuels. These opinions are prepared both directly and through organisations of which Grupa LOTOS is a member.

The biofuel and biocomponent area is dominated by the risks related to very slow proceedings of relevant Polish administrative bodies on the transposition of the Directive 2009/30/EC of the European Parliament and of the Council as of 23 April 2009 which facilitates the use of increased biocomponent amounts in fuels (B7, E10). Risk areas also include uncertainty as to the detailed scope of regulations to be adopted in domestic solutions during implementation of energy package directives, in particular Directive 2009/28/EC with regard to [sustainable development](#).

A major risk factor is also the intention to set higher thresholds of the [National Index Target](#) (NCW) for the forthcoming years, given the lack of Polish legislative solutions which would enforce the implementation of such thresholds. This may lead to penalties imposed for non-achievement of the NCWs or economically detrimental action undertaken in order to achieve the NCWs.

As regards mandatory reserves, the direction of future regulations in this regard is uncertain. We do not know the starting date of the mandatory reserves takeover from the companies operating in the market by the competent governmental agencies or the pace of that process, which may take up to 10 years.

Another potential problem, which may occur as early as in 2011, will be insufficient storage capacity for the mandatory reserves, in particular

for oil.

Risks related to changes and interpretations of the tax law

Frequent changes in tax provisions occur in the legal environment of Grupa LOTOS. New regulations being enforced and changes in the application of the existing provisions affect the way the Company pursues activities, the type of actions undertaken and the size of tax liabilities. Given the incessant changes in provisions, which are often incoherent, complex and incompatible with the Community regulations and the method of application of the existing provisions, internal procedures have been implemented to ensure that provisions of the law are observed and the tax risk is identified, minimised and monitored for impact on the financial statements of Grupa LOTOS. It is necessary to monitor the changes in the tax provisions and actively respond to such changes by harmonizing the internal systems of tax returns.

Frequent changes of regulations on excise tax, value added tax (VAT), corporate income tax, personal income tax and social insurance result in a lack of reference to fixed regulations or legal precedents. The interpretations of the Minister of Finance conflicting with judgments of the administrative courts make it impossible to predict uniform fiscal consequences for specific transactions.

Frequently occurring differences in opinions on the legal interpretation of fiscal regulations, both within the state authorities as well as among various authorities and enterprises, create areas of uncertainty and conflicts and as such lead to the loss of reliable business partners in foreign transactions. This state of affairs may also lead to resigning from profitable projects and transactions only to ensure fiscal safety for the Company.

Given these circumstances, the tax risk related to economic activities in Poland is considerably higher than in other countries with a much more developed fiscal system.

Additional factors which call for adequate tax risk management are high potential penalties for a tax offence or misdemeanour and the generally pro-fiscal approach of the Polish tax authorities. Entities engaged in economic activities must take into account the fact that following a mistaken interpretation of the law, an employee error, or incompetence of the officials, the entity may inadvertently create an outstanding tax liability. The tax authorities may carry out inspections and verify records of economic operations posted in the accounting books for a period of up to 5 years of the end of the tax year in which the tax returns were submitted.

Financial risks

The Financial Risk Management Committee operating in Grupa LOTOS is responsible for the supervision and co-ordination of the financial risk management process in the Company. The main goal of activities in this scope is to:

- reduce cash flow variability,
- increase the likelihood of achieving budgetary and strategic goals,
- ensure short-term financial liquidity,
- maximise results on market risk management with the assumed risk level,
- support projects aimed at organising financing for investment activities.

Management of the petroleum product and raw material price risk is of particular importance for Grupa LOTOS. The concept of the management of the petroleum product and raw material price risk covers the period to the end of 2010 which is in line with the completion horizon for the 10+ Programme.

In addition, the Committee works on the management of the **risk of prices of (CO₂) emission allowances** in accordance with assumptions contained in the “Strategy for the management of the risk of prices of CO₂ emission allowances in Grupa LOTOS”. Pursuant to various stages of the Kyoto Protocol, it currently covers the management horizon until the end of 2012.

Foreign exchange risk is managed in accordance with assumptions of the “Strategy for the management of the FX risk in Grupa LOTOS”, and the management horizon is set in accordance with the rolled planning period.

The US dollar (USD) is the natural currency of the operating market of Grupa LOTOS. The currency is used in oil and petroleum product price quotations. Therefore, Grupa LOTOS has a structurally long position in USD in connection with its operational activities. For this reason it was decided that the USD was the most appropriate currency to incur and repay long-term loans and finance the 10+ Programme.

Interest rate risk management is based on the expected repayment schedule for the loan incurred to finance the stocks and the 10+ Programme. The interest rate risk pertains to the interest fixed on the LIBOR USD variable interest rate.

Liquidity risk management in Grupa LOTOS consists of the monitoring of expected cash flows and available sources of financing and adjusting asset and liability maturity dates, the analysis of the working capital and the provision of access to various sources of financing.

Credit risk for financial transaction partners is managed through ongoing monitoring of the credit exposure for the limits set. The transaction partners must hold the appropriate rating awarded by the leading rating agencies or hold guaranties from institutions which meet the minimum rating requirement. Grupa LOTOS enters into financial transactions with reputable companies of good creditworthiness.

As regards the management of credit risk for non-financial transaction partners, all customers applying for trade credits undergo a creditworthiness assessment. Limits are awarded on the basis of results achieved. The evaluation of customers and limit awards are reviewed by the Credit Committees of the Capital Group's companies.

Given the current macroeconomic situation resulting from the global economic slowdown, the Management Board of Grupa LOTOS decided to intensify actions aimed at ensuring financial liquidity of the Company. The Anti-Crisis Package implemented at the beginning of 2009 brought considerable savings and improved cash flows. In 2010 Grupa LOTOS assumes further implementation of the cost effectiveness programmes.

The principles and instruments of financial risk management and the impact of the most important risk elements on the development of various areas of the financial results are presented in the consolidated financial statements under Additional information and explanations.

Risks related to exploration and exploitation activities

As a result of the global economic slowdown, the development strategy for the exploration and exploitation sector and plans for the implementation of the strategy could be verified and adapted to the economic operating conditions. Potential risks in the exploration and exploitation sector include:

- exploration risk for potential resources,
- limited access to external financing,
- variability of market conditions in terms of oil prices and US dollar and euro exchange rates,
- operational risks related to the exploitation of carbohydrates,

- low efficiency of the auxiliary activities which support the exploitation processes,
- the processing risk of deposit development.

It should also be stressed that as regards exploration and exploitation activities, preventive actions are being carried out on an ongoing basis. These actions involve the continuous monitoring of the market and macroeconomic factors, project evaluation, and the making of decisions on the basis of previous geological and deposit analyses.

Risks related to the raw material supply

Grupa LOTOS continues activities related to the adopted strategy of oil supply diversification by focusing on two key aspects of this strategic goal:

- the safety of oil supplies: clearing the alternative oil supply channel by establishing a presence in the international oil market, regular contracting of supplies of various brands of marine oil – with the potential for a dramatic increase in the share of such oil in total oil supplies if the continuity of supplies from the basic source is endangered,
- an improvement in competitiveness – through complete utilisation of the coastal location of the Gdańsk refinery and the possibility of receiving supplies from two independent channels: Russian oil through the Druzhba pipeline and various types of oil available through Naftoport. The appropriate selection of oil brands is based on ongoing optimisation.

Operating risks

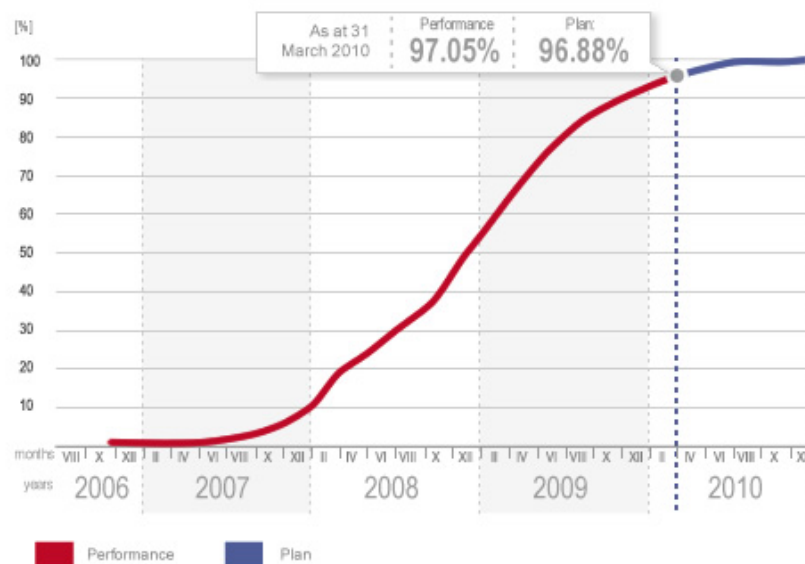
Risks related to the 10+ Programme implementation

Given the fact that the implementation of the 10+ Programme is nearing its end, the related risks are reduced. Still, the risks are being monitored and controlled. These risks include, among others:

- supply or installation of faulty devices and materials which calls for repairs or replacement and increases the costs and causes delays,

- economic downturn of the subcontractors caused by various phenomena resulting from the global crisis and resulting in delays in investment completion, loss of advance payments and the need to acquire additional materials,
- construction faults resulting from difficult working conditions or non-compliance with the procedures resulting in the suspension of works as well as budget delay and excess,
- failure to achieve full process parameters for the facilities being commissioned because of latent design defects resulting in lost profits or additional costs required to achieve the basic design parameters of the facility,
- adverse weather conditions resulting in delays and damage to the installed devices,
- protests and objections of persons or external institutions caused by the environmental impact of the investment resulting in the suspension of works and delays or the suspension of administrative decisions,
- accidents resulting from difficult working conditions or high intensity of work in the same area or OHS non-compliance,
- periodical suspension in lending resulting in the suspension of works from the lack of funds,
- the risk of euro appreciation when the majority of contracts is euro-denominated.

The progress of the 10+ Programme implementation



Environmental risks

There are certain environmental risks to the operations of Grupa LOTOS, the key risks being:

- the risk of non-compliance with the environmental law provisions and requirements (domestic and Community),
- the risk of lack of CO₂ emission allowances,
- the risk of a major industrial failure.

The likelihood of the risk related to non-compliance with the national and Community law is minimised by ongoing monitoring of the environmental law requirements, efficient implementation, and active and effective participation in the legislative process involving legal acts. Identified legal requirements pertaining to environmental protection in the form of information or orders are provided to all locations in the LOTOS Group, to which the provisions of the law pertain. The process of obtaining all the permits is carried out with proper time reserve which takes into account the risk of prolonged administrative proceedings and guarantees obtaining the appropriate document in time or in advance.

Risk management in relation to legislative changes also involves activities related to obtaining the sufficient number of allowances in a given time for facilities participating in the EU CO₂ emissions trading system and obtaining new allowances. The Company is implementing this process as part of the 10+ Programme. The commissioning of new facilities requires additional emission credits which may be awarded when the adequate documents are submitted to confirm that the new or modernized facilities achieved full manufacturing capabilities and the commissioning process is complete.

Comprehensive identification and update of environmental risks as well as preparation of the method of eliminating consequences of potential technological faults is necessary to reduce the likelihood of threats and minimise the effects of unwanted situations involving an industrial failure causing excessive pollution to air, water and/or ground. Preventive tests are carried out in the refinery to check the technical condition of the devices. The refinery also applies numerous modern warning and fault-prevention techniques, involving carbohydrate, hydrogen sulphide and flame sensors or visual monitoring of the pipeline routes. Regular training in failure response is carried out to ensure fast and effective response to potential failures.

Process and technical risks; risks related to occupational health and safety (OHS)

The process and technical risks involve threats related mainly to processed substances, technological processes, devices and equipment used, as well as operating conditions related to high pressure and temperature parameters.

The OHS risks are related to the exposure of personnel to onerous or harmful conditions connected with the performed work and the proximity of the technological processes which may ultimately lead to accidents at work or occupational diseases.

In accordance with the binding provisions of the law and internal regulations, the Company regularly identifies threats in each workplace and evaluates the occupational risk also for explosive atmosphere, noise, vibration, chemicals or biological substances in the working environment.

Generally used means and measures of work safety are aimed at minimising identified risks. Actions undertaken by the Company extend beyond the scope identified by the Polish legislation. In order to reduce the likelihood of unwanted events, Grupa LOTOS regularly implements new technical and organisational solutions to increase the awareness and involvement of the personnel and ensure safe working conditions for all the persons who remain and/or work in the vicinity of and for Grupa LOTOS.

The Concern also pays particular attention to procedural requirements obligating Grupa LOTOS to train the personnel in methods of operating complex devices and equipment or using hazardous substances. The system-wide principles and requirements, in particular employee compliance with rules of safe operation and work performance are strictly controlled and enforced.

For years, Grupa LOTOS has applied Best Available Techniques in the manufacturing processes. The process installations are fitted with safety and protection systems and multi-layered protection systems in addition to BAT (i.e. prevention, protection and counteraction layers).

Risk of stricter quality requirements applicable to petroleum products

Grupa LOTOS performs ongoing monitoring of drafts of new standards and ordinances affecting the sales and manufacturing activities of the Concern. The source of information about future changes in quality requirements is Technical Committee 222 of the Polish Committee for Standardization, competent for petroleum products and operating fluids. Through active participation in the works of the subcommittees of the Technical Committee 222, Grupa LOTOS is able to express its opinions on the new European standards when drafted.

Grupa LOTOS has an additional impact on the level of quality requirements, in particular requirements applicable to engine fuels, through participation in the works of an industry association, the Polish Organisation of Oil Industry and Trade. This participation considerably mitigates the risk of late adjustment to future quality standards applicable to petroleum products.

In 2010 a change in quality requirements for petrols and Diesel oil is planned, involving the modification of the permitted content of biocomponents. Work is underway to permit the marketing of petrols with an [ethanol](#) content of up to 10% and Diesel oil with a [FAME](#) content of up to 7%. Grupa LOTOS is already prepared for such changes which pose no threat to its continued operating activities.

Sales risks

Grupa LOTOS' macroeconomic environment has an important impact on the sale of the Company's products, particularly in the time of economic slowdown. During the economic crisis, the reliability and liquidity of business partners which is determined by the liquidity of their payers, becomes essential. That is why a policy providing for transaction security and the control of receivables is of prime importance.

The extent to which rules for the establishment of collaterals are applied, and the current and future standing of market entities will be mainly determined by the policies of financial and insurance institutions. A more restrictive credit policy may mean that access to collaterals applicable to trade transactions such like insurance guarantees, insurances, letters of credit, working-capital and investment loans, will be limited or completely unavailable.

Thus, in 2009 and 2010, key risks of the trade activity of Grupa LOTOS comprise:

- reduced demand for fuels and other petroleum products resulting from the world-wide economic recession which may contribute to a smaller growth of sales than assumed;
- the appearance of new importers of petroleum products from various geographical territories, seeking sales opportunities in Poland and running aggressive pricing policies,
- competitors' aggressive pricing policies,
- reduced transit of goods through Poland,
- reduced number of air flights in the world,
- reduced number of road contracts and extending bid procedures related to road investments,

- reduced traffic of ships in Polish ports as a result of a drop in export/import,
- reduced industrial production resulting in smaller demand for lubricants, fuels and other petroleum products.

Risks and opportunities related to the Company's social situation

The effects of the global economic slowdown observed in Poland resulted in changes in the Company's operations. In 2009, an Anti-Crisis Package was introduced and projects to improve the efficiency of operations were initiated, bringing savings in particular segments of the Company's activities. Meetings between staff and senior management, on-going information on the Company's standing, surveys among the employees of the Capital Group, as well as periodic meetings under the internal communication "Let's talk about LOTOS" programme produced active cooperation between the staff and the management in implementing the provisions of the Anti-Crisis Package. Owing to the significant commitment of the staff and the management, the cost discipline and the implementation of new system solutions, we managed to achieve the budgeted economic ratios and savings set out in the Anti-Crisis Package. The Company's situation is stable and employees have a great sense of responsibility for the results of their work. Currently, no significant risks of the social nature are identified. The implementation of the 10+ Programme resulted in the necessity of additional staffing in the production and technology divisions. The recruitment of young, educated and committed employees allowed a change in the age structure and the introduction of new innovative solutions.

Costs of the implementation of hedging strategies

While planning strategies to secure against risks, the Company analyses necessary expenses and potential benefits arising therefrom. Such expenses should not exceed the financial consequences that Grupa LOTOS would have to bear if the risks materialised. Therefore, all risk reduction plans are implemented upon their profitability analysis.

Expected changes in identified risks

Grupa LOTOS analysed how the identified risks might develop till 2012. It was evaluated to what extent the probability and financial consequences of such risks may change in that period. As an effect of the above analyses, it was observed that many risks would have a comparable impact on the Grupa LOTOS in the whole term of the strategy. When the 10+ Programme is completed, operational risks and the related risk of reduced access to external sources of finance will decrease. However, risks relating to competitive activities are likely to increase because of the bigger probability thereof. This is why Grupa LOTOS undertakes the relevant actions and implements adequate

strategies to prevent risk consequences.