



LOTOS Group
Integrated Annual Report 2018

04. **STRATEGY IMPLEMENTATION IN 2018**

Efficiency in action – achievement of strategic objectives in 2018

Last year we continued our efforts designed to operationalise the LOTOS Group's 'Stability and sustainable growth' strategy for 2017–2022. The strategy contains five key strategic metrics to assess the progress of its implementation.

STRATEGY METRICS

- Twofold increase in average annual LIFO-based EBITDA in 2019–2022,
- Reduction of net debt/LIFO-based EBITDA to or below 1.5,
- CAPEX of PLN 9.4bn over six years,
- 2P reserves at more than 60 mboe and daily hydrocarbon production of 30,000-50,000 boe,
- Increase in the number of service stations to 550 with LTIF 9.

OUR STRATEGY FOR 2017–2022, ALSO SETTING FIVE KEY OBJECTIVES, WHOSE DELIVERY IS CLOSELY MONITORED

OBJECTIVE 1: Effective use of assets along the value chain

We reorganised the exploration and production segment

In 2018, we completed the reorganisation of the exploration and production segment, resulting in the establishment of two separate specialised entities: The LOTOS Upstream Group, investing in production assets, and the LOTOS Petrobaltic Group, engaged in operating activities. Moreover, LOTOS Upstream UK was registered in 2018 with a view to expanding operations on the British Shelf in the future.

The LOTOS Upstream Group is running two projects which are now at a development stage (Utgard and YME located on the Norwegian Continental Shelf, with production launch scheduled for 2020) and two projects at a pre-development stage (B4/B6 in the Baltic Sea and NOAKA).

The LOTOS Petrobaltic Group is a licence holder and operator for the B3 and B8 fields in the Baltic Sea and holds exploration and production licences in the Baltic Sea (for the Łeba, Rozewie, and Gotland areas). The LOTOS Petrobaltic Group plans to expand its business by offering offshore and logistics services to external customers.

The reorganisation was also intended to streamline financial links within the segment.

We invested in innovative technologies

Our main investment project pursued in recent years is EFRA, which will facilitate deeper and more economically viable conversion of crude oil thanks to the construction of a state-of-the-art coking unit. Total progress of work under the EFRA Project as at the end of December 2018 was 98.1%. At the same time, we carried out analyses and prepared for further development of the refinery also in other directions, as specified in our strategy:

- Lubricate blending unit for the production of Group 2 and 3 base oils,
- Gasoline complex for the production of motor gasolines from naphta,
- Olefins complex with an ETBE unit and a project to construct a captive CHP plant.

We developed our service stations

The LOTOS Group company in charge of retail operations is LOTOS Paliwa.

NASZE STACJE W LICZBACH NA KONIEC 2018 R.

495 service stations
under the LOTOS brand

306 stations
CODO

189 stations
DOFO

20 Areas
Motorway Service

24 Subway restaurants
within the LOTOS chain

12 EV charging points
along the Tricity – Warsaw
route

In 2018, we updated our offering for franchisees by expanding our support in the store segment and making fuel pricing more attractive. We also worked on further standardisation of the service station chain, enhancing the non-fuel offering, and improving customer service standards. In partnership with Alior Bank, we launched the Mastercard Business LOTOS credit card. All these efforts improved last year's overall chain profitability.

At our service stations we also implemented solutions supporting electric mobility. As part of the LOTOS Blue Trail project, 12 charging points were launched along the Tricity – Warsaw route. Another 38 EV charging points are to be opened by the end of Q1 2020, many of which will be located not only in northern and central Poland, but also along the routes in the west and south of the country. Plans envisage the construction of more EV charging points along expressways and motorways.

OBJECTIVE 2: Effective processes to ensure stability

Last year, we launched the Efficiency Improvement Programme, designed to support the identification and reporting of cost-saving measures at the LOTOS Group.

OPTIMISATION PROCESSES AT THE LOTOS GROUP

250

number of measures identified as part of the Efficiency Improvement Programme

165

number of approved measures

85

number of cost-saving measures completed at the end of 2018

Transport and Logistics, Refining and Energy, and HR/Business trips – these are the areas where cost savings were the most significant in 2018

10.8

m tonnes refining throughput in 2018

the highest in the LOTOS Group's history

We diversified the supply of raw materials

Feedstock diversification ensures the continuity and stability of crude oil supplies to the Grupa LOTOS refinery, improves the efficiency of refining operations, and expands the knowledge of and experience in the processing of various types of crude. It allows the LOTOS Group to quickly and actively respond to market developments and generate higher margins. Last year, 27% of the crude oil we purchased was imported from sources other than markets east of Poland.

We consolidated our leading position

In 2018, the LOTOS Group strove to strengthen its position in the Solomon Associates ranking. To this end, it took measures aimed at improving the refinery's energy efficiency and launching the latest IT solutions with a view to implementing the Industry 4.0 concept.

OBJECTIVE 3: Readiness to embrace innovation

Last year, we carried out a number of initiatives reflecting our innovative thinking about business. We launched the Pure H2 project to construct a hydrogen treatment and dispensing unit together with two hydrogen refuelling points (to be placed in service in Gdańsk and Warsaw by the end of 2021). We also continued work on 'A feasibility study concerning the construction of a small scale LNG terminal in Gdańsk and innovative LNG bunkering facilities'. Both of these initiatives are EU funded under the Connecting Europe Facility. We also carried on work on biofuel technology and co-hydrogenation in our units. In addition, we started research and development cooperation with the Warsaw University of Technology.

OBJECTIVE 4: Active opportunity and risk management

We are constantly developing and strengthening our risk and opportunity management capabilities. In the previous year, we expanded our methodology for corporate risk management, supported by the LOTOS Group Risk Committee. We also implemented TOP RISK, a system for monitoring and describing key risks. We regularly conduct workshops to improve risk management and identify market opportunities at the LOTOS Group. We promote a culture of open risk communication to enable a quick and effective reaction, thus minimising the probability and mitigating the consequences of risk materialisation, and to take advantage of opportunities as they arise.

OBJECTIVE 5: Strong team, coherent CSR story and safety

We promote talents

Among our priorities is consistent professional development of our staff, especially talent identification and promotion. Last year, we continued work on a knowledge management system based on an e-learning platform. We also carried out projects designed to support the professional development of our management staff (e.g. we developed a map of desired managerial competences, identified the potential of management staff, and developed Individual Development Plans) and took measures to optimise HR processes and better align them with the expectations of employees and managers (we developed IT systems supporting HR processes and streamlined communication with employees). Our efforts are appreciated. Last year, for the fourth time we received the Top-Quality Human Resources Certificate from the Polish Human Resources Management Association.



For more information on our HR activities, see: [Employees](#)

We pursue an integrated CSR policy

In 2018, we remained committed to solving social and environmental problems of our stakeholders. Our efforts in this area focus in particular on social and sports matters, improvement of road traffic safety, and environmental protection. Our CSR policy is also pursued through the LOTOS Foundation, which supports safety-oriented, eco-friendly, and educational initiatives.

Also in this area our efforts were recognised. In 2018, Grupa LOTOS was again included by the Warsaw Stock Exchange in its RESPECT Index of socially responsible companies. In addition, Grupa LOTOS shares were for the first time included by global rating agency FTSE Russel in FTSE4Good, London Stock Exchange's index of ethical investment stocks. The Polityka weekly again awarded us the CSR Silver Leaf.



For more information on our CSR activities, see: [Sustainable development](#)

We have a robust safety culture




The safety of our employees is our absolute priority. We continuously take steps promoting safe working culture. Last year, we organised the Safety and Health Days for the ninth time. We also carry out regular safety information campaigns and undertake motivational measures. It is also crucial for us to protect infrastructure of key importance to Poland's energy security. With this goal in mind, we have implemented a programme to increase cyber security by creating appropriate organisational structures, implementing the necessary tools, new technological and infrastructure solutions, as well as educational initiatives.

Calendar of key events

January

 <p>Grupa LOTOS signed an agreement with PZPN (Polish Football Association) under which it will remain the Principal Sponsor of the Polish National Football Team until 2022.</p>	 <p>LOTOS Norge received two new exploration and production licences from the Norwegian authorities. The company already holds 28 Norwegian licences.</p>	 <p>The LOTOS service station chain won the tender for the lease of two Motorway Service Areas on the S8 expressway.</p>	 <p>Grupa LOTOS and Remontowa LNG Systems signed a letter of intent to build a pilot LNG dispensing system.</p>
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February

 <p>Grupa LOTOS started to develop a modern remuneration, bonus, and employee benefit system.</p>	 <p>LOTOS Terminale received an 'Employee-Friendly Business' certificate from the President of the Republic of Poland.</p>	 <p>LOTOS Upstream commenced operations, with LOTOS Norge and LOTOS Geonafta included in its group.</p>
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March

<p>Mateusz A. Bonca was appointed President of Grupa LOTOS S.A. Management Board and Piotr Ciach was appointed Management Board member.</p>	<p>The Electric Power Research Institute (EPRI) from the Silicon Valley, one of the most important research organisations in the energy sector, opened its offices on the premises of Grupa LOTOS.</p>	<p>LOTOS Paliwa was named the Customer Service Quality Star 2018 in the service stations category.</p>	<p>At the Sports and Business Gala, Grupa LOTOS was awarded prizes in the 'Sports Sponsor' and 'Marketing Campaign' categories for its sponsorship initiatives and the 'THE BEST doesn't come from nowhere' campaign.</p>
<p>LOTOS station No. 404 in Pruszków won in the 'Carwash' category, and LOTOS P218 station in Białystok won in the 'DOFO Service Station in Eastern Poland' category during the PetroTrend 2018 forum.</p>			

April



LOTOS Asphalt and PGNiG Obrót Detaliczny signed an agreement on cooperation on LNG vessel bunkering service.



TELEWIZJA POLSKA

Grupa LOTOS met in Warsaw with representatives of the Polish Post Office and Polish Television to initiate cooperation in identifying potential business synergies that could support the development of low-emission transport in Poland.



LOTOS Oil created a network of Ambassadors of the LOTOS Engine Oil Brand, won 'Laur Konsumenta' (Consumer's Laurel) in the engine oil category and was awarded in the 'Eagles of Wprost' competition organised by the Wprost weekly.



Grupa LOTOS signed a letter of intent with the City of Gdynia concerning the supply of hydrogen to power fuel cell buses.

May



The Supervisory Board of Grupa LOTOS S.A. appointed three members to the Management Board of the tenth term of office. Mateusz A. Bonca was appointed President of the Management Board, Jarosław Kawula was reappointed Vice President of the Management Board, Chief Refining and Marketing Officer, and Patryk Demski was appointed Vice President of the Management Board, Chief Investment and Innovation Officer.

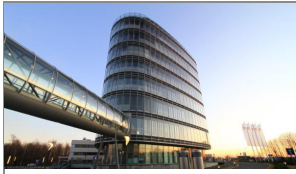


LOTOS Asphalt received a medal at AUTOSTRADA-POLSKA International Road Construction Fairs.



The Polityka weekly awarded Grupa LOTOS with the CSR Silver Leaf.

June



The Supervisory Board of Grupa LOTOS S.A. appointed Robert Sobków Vice President of the Management Board, Chief Financial Officer.



Grupa LOTOS came second in the 'Fuels, Energy, Production' category in the Socially Responsible Companies Ranking. In the overall ranking, the Company came sixth.



Robert Kubica was appointed the Ambassador of the Dynamic brand.



In the 'Fleet Derby 2018' poll, the LOTOS Biznes card was again recognised as the best fuel card in Poland.



The General Meeting of Grupa LOTOS S.A. passed a resolution to allocate approximately PLN 185m to dividend payment.

July



The overhaul of several units was completed and the refinery increased its production.



Seismic surveys on the Młynary Licence area were completed.

August



Hydrogen production was initiated at a new HGU 3 unit.



In August, the refinery processed 954.5 thousand tonnes of crude oil, which in annual terms would be 11.24 million tonnes.



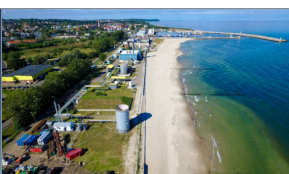
September

	<p>FTSE4Good</p>		
<p>The Supervisory Board of Grupa LOTOS S.A. appointed Jarosław Wittstock to the Management Board of the tenth term of office as Vice President, Corporate Affairs.</p>	<p>The global rating agency FTSE Russell of London included Grupa LOTOS S.A. stock in the prestigious FTSE4Good index of socially responsible companies.</p>	<p>The Supervisory Board of LOTOS Petrobaltic S.A. appointed Grzegorz Strzelczyk President of the Management Board and Sławomir Sadowski Vice President of the Management Board, Chief Operating Officer.</p>	<p>Representatives of the Warsaw University of Technology, Grupa LOTOS S.A. and LOTOS Lab signed an agreement initiating joint research and development activities.</p>

October

<p>Decision was made to allocate EU funding of approximately EUR 2m to the Pure H2 project (construction of a hydrogen treatment unit and two hydrogen refuelling points).</p>	<p>LOTOS Lab and LOTOS Kolej commenced a project to build two prototype shunting locomotives with hybrid drive systems.</p>	<p>At Automechanika Frankfurt 2018 fair, LOTOS Oil's stand received an honorary distinction.</p>	<p>Innovative tests of hydrogenation of vegetable oils at the HDS 520 unit were completed with success.</p>
<p>LOTOS launched the Blue Trail – 12 electric vehicle charging points between Warsaw and Gdynia, along the A1 and A2 motorways.</p>			

November

		
<p>A year-long upgrade of unloading track 210, to which biocomponents are delivered by rail, was completed.</p>	<p>Grupa LOTOS and a syndicate of nine banks extended the agreement on refinancing oil and fuel stocks.</p>	<p>LOTOS Petrobaltic completed the construction of a 75 km gas pipeline connecting the production hub on the B8 field with Energobaltic's CHP plant in Władystawowo.</p>

December

			
<p>Grupa LOTOS was for the 12th time included in the RESPECT Index comprising the most socially responsible companies.</p>	<p>Grupa LOTOS and Microsoft signed an agreement on initiating joint projects and implementing solutions using artificial intelligence and state-of-the-art IT technologies.</p>	<p>LOTOS Kolej and the Ministry of Investments and Development signed an agreement on the provision of PLN 74m in EU funds for the purchase of modern intermodal rolling stock.</p>	<p>On December 23rd, the Grupa LOTOS refinery achieved a record crude oil throughput of 10.5m tonnes per year. By the end of the year, it processed 10.8m tonnes.</p>

Financial results and operational achievements

Record performance and sustainable management of financial capital

Last year was a good one for the LOTOS Group in terms of financial performance. Our revenue was significantly higher than in 2017, mainly as a result of higher prices of crude oil and petroleum products on global markets. There was also an increase in the average statistical net revenue per tonne and in the volume of petroleum products, merchandise, and materials sold. We reported the strongest increases in diesel oil and heavy products. The higher sales also translated into a rise in costs.

THE LOTOS GROUP'S FINANCE

PLN

30.121 bn

total revenue in 2018

24.5% – increase in revenue relative to 2017

PLN

2 455 /t (toe)

average statistical net revenue per tonne in 2018

17.9% – increase in average statistical net revenue per tonne relative to 2017

5.7 %

increase in sales volumes of petroleum products, merchandise and materials relative to 2017

7.3 %

increase in unit gross margin in 2018 relative to 2017

PLN

4.529 bn

LOTOS Group's consolidated gross profit

13.5% – increase in consolidated gross profit compared with 2017

PLN

25.592 bn

LOTOS Group's cost of sales in 2018

26.7% – increase in LOTOS Group's cost of sales compared with 2017

PLN

230 m

LOTOS Group's net other income in 2018

The 2018 increase in our operating profit was driven mainly by higher average annual prices of crude oil and natural gas, higher margins on key petroleum products, the uptrend in crude oil and petroleum product prices in the first three quarters of 2018, and higher sales volumes.

The higher revenue and operating profit reported by the E&P segment in 2018 were primarily driven by growing prices of Brent Dated crude (up 31.4%) and natural gas (up 38.8%) on global markets.

The higher revenue of the Refining and Marketing segment in 2018 was mainly due to a 17% increase in the average selling price following from higher prices of petroleum products on global markets, offset by a lower USD/PLN exchange rate, as well as a rise in the sales volumes of petroleum products. The segment's 11.4% increase in operating profit for 2018 was partly related to the 'Spring 2017' maintenance shutdown.

KEY FINANCIAL RESULTS OF THE LOTOS GROUP

PLN
2.98_{bn}
 LOTOS Group's operating profit for 2018

PLN
1.59_{bn}
 LOTOS Group's net profit for 2018

PLN
1.93_{bn}
 Refining and Marketing segment's operating profit

PLN
1.05_{bn}
 Exploration and Production segment's operating profit

PLN
30.12_{bn}
 revenue

PLN
5.94_{bn}
 year-on-year increase in revenue

LOTOS GROUP'S REVENUE BY PRODUCT CATEGORY:

	2018		2017	
	(PLNm)	share (%)	(PLNm)	share (%)
Gasolines	4 450.5	14.8%	3 682.2	15.2%
Naphtha	1 157.1	3.8%	859.6	3.6%
Diesel oils	15 009.3	49.8%	11 864.5	49.1%
Bunker fuel	201.2	0.7%	121.3	0.5%
Light fuel oil	640.4	2.1%	646.9	2.7%
Heavy products	3 133.8	10.4%	2 314.8	9.6%
Aviation fuel	1 421.7	4.7%	913.1	3.8%
Lubricating oil	278.5	0.9%	297.3	1.2%
Base oils	587.3	2.0%	488.6	2.0%
LPG	543.8	1.8%	496.1	2.0%
Crude oil commodity	320.8	1.1%	432.6	1.8%
Crude oil product	285.4	0.9%	252.2	1.0%
Natural gas	662.1	2.2%	574.7	2.4%
Other refinery products, merchandise and materials	563.7	1.9%	440.5	1.8%
Other products, merchandise and materials	537.4	1.8%	463.2	1.9%
Services	420.3	1.4%	488.5	2.0%
Effect of cash flow hedge accounting	-91.6	-0.3%	-150.5	-0.6%
Total	30 121.7	100.0%	24 185.6	100.0%
Domestic sales	23 263.0	77.2%	19 090.5	78.9%
Export sales	6 858.7	22.8%	5 095.1	21.1%

AKTYWA

The main changes in assets were as follows:

- **A PLN 1.3bn** increase in inventories (mainly of crude oil and petroleum products), attributable chiefly to higher stocks of oil (including emergency stocks) and finished and semi-finished petroleum products, as well as higher prices as at the end of 2018 vs the end of 2017.
- **A PLN 639.8m** increase in E&P segment's property, plant and equipment, attributable mainly to the reversal of impairment losses on expenditure on YME.
- **A PLN 796.6m** decrease in trade receivables, mainly on the back of crude oil sold in December 2017 under contracts with the Material Reserves Agency.
- **A PLN 265.8m** decrease in deferred tax assets, attributable mainly to the reversal of impairment losses on expenditure on YME and insurance proceeds received in respect of the defective platform on the YME field.
- **A PLN 290.9m** increase in other assets, primarily attributable to the funds held in the Sleipner decommissioning escrow account.
- **A PLN 140.1m** decrease in positive fair value of financial derivatives.

Last year also saw an increase in LOTOS Group's consolidated equity. The increase was driven primarily by higher retained earnings (up PLN 1.4bn), which were decreased by foreign exchange losses on valuation of cash flow hedges, recognised in capital reserves, adjusted by the tax effect of PLN -63.0m.

EQUITY

PLN

12.03_{bn}

equity at the end of 2018

PLN

1.32_{bn}

increase in LOTOS Group's equity relative to 2017

54.2%

share of equity in total equity and liabilities in 2018

3.6%

increase in the share of equity in total equity and liabilities relative to 2017

KEY CHANGES IN LIABILITIES (DOWN BY PLN 269.6M):

PLN

+170.9_m

increase in other liabilities and provisions (mainly provisions recognised in the Refining and Marketing segment and provisions remeasured in the Exploration and Production segment)

PLN

+355.3_m

increase in current tax liabilities

PLN

-288.0_m

decrease in trade payables

PLN

-541.9_m

decrease in borrowings, other debt instruments and finance lease liabilities, reflecting mainly a partial repayment of the Parent's investment facilities, loans contracted by LOTOS Norge S.A. and AB LOTOS Geonafta, as well as redemption of some of the bonds issued by the Group

In 2018, the LOTOS Group's financial debt decreased relative to 2017. The ratio of financial debt adjusted for free cash to equity was 16.1%, down 7.3 pp.

DEBT

PLN

3.88_{bn}

LOTOS Group's financial debt at the end of 2018

PLN

541.9_m

decrease in LOTOS Group's financial debt relative to 2017

PLN

1.94_{bn}

net financial debt as at the end of 2018

As at the end of 2018, our cash balance, including current account overdrafts, was PLN 1.94bn, up PLN 17.7m year on year.

Positive cash flows from operating activities were driven mainly by net profit before depreciation and amortisation, income tax and lower trade receivables, which were offset by higher inventories, impairment losses on property, plant and equipment and intangible assets, and lower trade payables.

Negative cash flows from operating activities primarily included expenditure on main growth projects, including the EFRA project, and on hydrocarbon production from the Norwegian and Baltic fields, as well as funds in the Sleipner decommissioning escrow account.

Negative cash flows from financing activities were due mainly to borrowings, repayments of borrowings and payment of interest, dividend paid, and negative balance of proceeds from issue and redemption of the Group's bonds.

PLN

1.94_{bn}

LOTOS Group's cash balance, including current

PLN

2.33_{bn}

positive cash flows from operating activities generated in 2018

PLN

-1.09_{bn}

negative cash flows from investing activities generated in 2018

PLN

-1.24_{bn}

negative cash flows from financing activities



More in Section: Financial results and operational achievements



Skonsolidowane Sprawozdanie Finansowe 2018

We invest in the future

In 2018, the LOTOS Group's capital expenditure exceeded PLN 1bn, most of which was spent on the construction of a delayed coking unit (EFRA Project) and on oil and gas production, mainly from the B8 field in the Baltic Sea and from the Sleipner and YME area fields on the Norwegian Continental Shelf.

LOTOS GROUP'S CAPITAL EXPENDITURE IN 2018

by key Refining & Marketing projects (PLNm)

Refining & Marketing segment	2018
EFRA	290.4
Expansion of service station network	63.5
Hydrogen Recovery Unit (HRU)	11.5
Other	77.8
Total	443.2

LOTOS GROUP'S CAPITAL EXPENDITURE IN 2018

by key Exploration & Production projects (PLNm)

Exploration & Production segment	2018
B8 field	132.8
Sleipner, Norway	127.4
Heimdal, Norway	14.7
YME, Norway	212.9
Other	73.0
Total	560.8


 OPERATIONS OF GRUPA LOTOS S.A. AND THE LOTOS GROUP, page 39

We support economic growth

As Poland's second largest fuel company, we have a direct and indirect effect on the country's economy. The development of the regions where we operate is driven by taxes we pay and a diversified supplier network.

TAXES AND CHARGES PAID BY THE LOTOS GROUP (PLNM)

Taxes and charges by country	2018
Poland	509.1
Norway	21.6
Lithuania	11.0
Total	541.7

We support local entrepreneurs by improving conditions for further growth of small and medium-sized businesses. LOTOS Oil, one of our companies, plays an important role in stimulating local economy. It works with numerous local suppliers of goods and services, for whom establishing business relationships with LOTOS undoubtedly presents a growth opportunity. As a result, more jobs are created in the regions in which those businesses operate.

In 2018, 20.80% of our procurement budget was spent on goods and serviced purchased from local companies from Gdańsk and the surrounding area.

We are a major employer not only in the Gdańsk Province – our service stations are a workplace for people also in other regions of Poland. Total workforce at the LOTOS Group is **5,045**. In 2018, we paid **PLN 761.6m** in salaries and wages.

The funds paid to our employees and suppliers indirectly contribute to improving the economic situation of the regions where we are present. The money they put in circulation supports other local businesses and improves the quality of life of local communities.

Our broad offering is also designed to bridge the gap in access to consumer goods for low-income customers. LOTOS Oil products are widely available and come in different prices so that they can be purchased by both more and less affluent individuals.

The LOTOS Group also pursues a number of innovation and efficiency improvement initiatives to reduce process and energy costs. In this way we seek to counteract the rising global prices of energy carriers and thus prevent energy poverty.