THE LOTOS GROUP

DIRECTORS' REPORT ON THE FINANCIAL RESULTS OF THE LOTOS GROUP

FOR Q4 2006

Gdańsk, February 28th 2007

Introduction

In Q4 2006, the activities of the Management Board of Grupa LOTOS S.A. focused on continued technological development, maximum utilisation of production capacity, optimising the use of the LOTOS Group's production assets and further strengthening of the Company's market position. These activities, aimed at increasing shareholder value, were pursued as part of the Comprehensive Technical Upgrade Programme (the PKRT Project), the development programme for oil production and supply, the PROSTA Programme, and the trading structure optimisation programme.

As concerns the PKRT Project, our efforts in Q4 2006 focused mainly on continued work on the technological development of the Project and selection of contractors for the implementation of the investments. In particular, we signed a contract with ABB Lummus Global for the construction of the diesel oil hydrodesulphurisation (HDS) unit for, took steps with a view to commencing the construction of a new crude distillation unit (CDU) in accordance with the contract with Uhde Edeleanu signed in Q3 2006, and conducted negotiations with Fluor and the UHDE/Technip consortium on the terms and conditions of the bids submitted by those companies for the execution of the Front End Engineering Design for the PKRT Project. As regards the mild-hydrocracking unit (MHC) construction project, work commenced on the execution of orders for reactors.

In Q4 2006, as part of the PROSTA Programme we continued activities aimed at building a modern nationwide network of LOTOS fuel stations. Our efforts were mainly focused on continued development of the COCO/CODO and DOFO stations network.

As for the Southern Refineries, in Q4 2006 the Group carried on the restructuring efforts to adapt LOTOS Czechowice and LOTOS Jasło to operate within the LOTOS Group, and implemented the programme intended to rearrange the structure of the LOTOS Group.

Q4 2006 saw further deterioration of market conditions, particularly those affecting the oil refining business. The average price of Brent oil stood at USD 59.60 per barrel and was lower by USD 10 per barrel, or 14.4%, than in Q3 2006. Lower oil prices were accompanied by a further reduction of the Ural/Brent differential, which in Q4 2006 fell to USD 3.51 per barrel, down by 5.3% on Q3 2006. In Q4 2006, the average refining margin decreased by 43.4%, to USD 2.96 per barrel, versus USD 5.23 per barrel in Q3 2006. The Q4 2006 refining margin fell by 50.0% year on year. Thanks to strong demand for petroleum products, in Q4 2006 our capacity utilisation was very high, and reached nearly 105% of the designed capacity.

In the four quarters of 2006, the consolidated sales revenue of the LOTOS Group amounted to PLN 12,812.7m, operating profit was PLN 804.8m, net profit stood at PLN 715.2m, the net profit attributable to shareholders of the dominant entity (i.e. net of minority interests) was PLN 666.1m. Compared with the corresponding period of 2005, sales revenue went up by 32.8%, while operating profit, net profit, and net profit attributable to shareholders of the dominant entity fell by 24.8%, 26.2%, and 27.2%, respectively. The factor which had a decisive effect on financial performance as compared with the corresponding period of the previous year was the PLN 266.6m negative goodwill (relating to recognition of an excess of the share in net assets of the Southern Refineries and Petrobaltic, acquired on February 3rd 2005, over the acquisition cost), which drove up the Q1 2005 operating profit. If the negative goodwill recognition is taken into account and the Company's financial results for the four quarters of 2005 are adjusted for its impact and compared with the results for the four quarters of 2006, it turns out that operating profit for Q1-Q4 2006 increased by PLN 1.1m (0.1%), while net profit rose by PLN 17.6m (2.7%).

Even more favourable is the comparison of the Company's performance with the LIFO method applied to the inventory valuation, both when presented on a cumulative and quarter-on-quarter basis. Compared with the corresponding period of 2005, the Q4 2006 operating profit rose by 50.8%, to PLN 253.4m, and the cumulative operating profit went up by 19.3%, reaching PLN 937.3m. After adjusting the LIFO operating result for the four quarters of 2005 for the negative goodwill described above and comparing it with the cumulative operating result generated after the four quarters of 2006, it turns out that the Company's operating profit increased by PLN 418.3m, i.e. by 80.6%.

Comprehensive Technical Upgrade Programme

As concerns the execution of the Comprehensive Technical Upgrade Programme (PKRT Project), which is the Company's largest investment project and an initiative of key importance for future growth of the Company's value, the activities pursued by Grupa LOTOS S.A. in Q4 2006 focused on further technological development and selection of contractors for the implementation of investment tasks under the Project.

Upon completion in Q3 2006 of the two-stage tender for the construction of the diesel oil HDS unit for, which resulted in selection of the contractor and commencement of contract negotiations, on November 11th 2006 the Management Board of Grupa Lotos S.A. signed a turn-key contract for the construction of the unit with ABB Lummus Global. Under the terms of the contract, the scope of the work comprises the technical design, deliveries and construction of the HDS unit. The unit will be constructed under a licence from Chevron Lummus Global. It will enable the Group to meet the quality requirements which are to apply to diesel oils as of 2009 (sulphur content of 10 ppm).

In Q4 2006, we continued efforts to commence the construction of a new CDU unit as part of the Front End Engineering Design Contract of August 2006 concluded with Uhde Edeleanu. Given the significant progress of the work, in December 2006 invitations to tender for the construction of the CDU unit were sent to six leading engineering companies. Submission of the bids is expected by the end of February 2007. Following the construction of the new CDU unit, the crude oil throughput in the Gdańsk refinery of the LOTOS Group will increase to 10.5m tonnes per annum in 2010 and the Company will no longer have to depend on imports of additional feedstock for the PKRT units.

Following the Q2 2006 decision of the Company's Supervisory Board concerning the delivery of four reactors for the MHC unit as part of the PKRT Project, in Q4 2006 execution of orders for the reactors was begun and the work on their construction proceeded smoothly. The launch and beginning of the construction work on the reactors (equipment with the longest delivery period) is a milestone in the PKRT Project implementation schedule.

After the signing of relevant agreements with Fluor and the UHDE/Technip consortium in the first quarter of 2006, the subsequent quarters of 2006 were a time of intensive work on the development of the Front End Engineering Design for the PKRT Project, and on the preparation of UHDE's and Technip's bids for implementation of the Project (excluding the scope of work covered by the contracts for the construction of HDS and CDU units). The bids for execution of the Project were submitted in mid December. The LOTOS Group is currently conducting negotiations with the bidders to optimise the scope and terms and conditions of the submitted bids.

In the period under review, the Group continued preparatory work on the construction site located on the Gdańsk refinery grounds. The work included soil survey, soil removal, ground levelling, draining, demolition and removal of structures from the construction site, providing electricity to the site, building temporary roads, etc. At the end of 2006, all the preparatory work was practically completed.

PROSTA Programme

The Company's activities in Q4 2006 related to the development of the retail fuel distribution network, pursued by the subsidiary undertaking LOTOS Paliwa as part of the PROSTA Programme, focused on continued expansion of the COCO/CODO and DOFO stations network.

The following actions commenced in previous quarters were continued in the reporting period:

- COCO stations were opened in Gdynia and Rzeszów,
- construction work on another COCO station in Katowice was finished (the station was opened on January 5th 2007),
- a comprehensive programme of installing LPG modules at fuel stations purchased from ExxonMobil Poland Sp. z o.o. and Slovnaft was continued,
- five new DOFO stations were added to the LOTOS Family Commercial Partnership Programme.

Furthermore, Q4 2006 saw the continuation of divestment processes aimed at optimising the structure of the fuel stations network and rationalising the real estate assets.

As at December 31st 2006, the LOTOS retail network was comprised of 401 fuel stations, including 132 COCO/CODO stations, 57 DOFO stations and 212 DODO stations. As at the end of 2006, all stations purchased from ExxonMobil Poland Sp. z o.o. and Slovnaft operated under the LOTOS brand.

Petrobaltic and Production Activities

On October 5th 2006, Petrobaltic completed test production on the B-8 oil field (carried out in the first three quarters of 2006 and continued in the fourth quarter). The Q4 production from this oil field amounted to 0.9 thousand tonnes of crude oil. In Q4 2006, the production from the B-3 and B-8 reservoirs totalled over 52.8 thousand tonnes of crude oil. All of the oil produced in Q4 2006 was sent as feedstock to the refinery in Gdańsk.

Southern Refineries (LOTOS Czechowice and LOTOS Jasło)

In Q4 2006, further restructuring work was carried out to adapt LOTOS Jasło S.A. and LOTOS Czechowice S.A. to operate within the LOTOS Group. The Group also implemented a programme aimed at optimising the Group's structure.

At the end of December, following court approval, the merger of LOTOS Czechowice S.A. and a subsidiary CBA RACER Sp. z o.o. was completed. In December 2006, liquidation proceedings were instigated with respect to RC Paliwa Sp. z o.o. – a subsidiary of LOTOS Czechowice S.A.

At the beginning of December 2006, LOTOS Jasło S.A. acquired 9,866 shares, with a par value of PLN 500 per share (and total par value of PLN 4,933,000), in the increased share capital of LOTOS Park Technologiczny Sp. z o.o. in exchange for a contribution in kind.

The transaction between LOTOS Jasło S.A. and LOTOS Park Technologiczny Sp. z o.o. was concluded on December 6th 2006 by way of an agreement on the transfer of perpetual usufruct right to land, and ownership of buildings, structures, plant and equipment, to LOTOS Park Technologiczny Sp. z o.o., in order to cover an increase in the share capital of LOTOS Park Technologiczny Sp. z o.o. to PLN 17,307 thousand. Following the registration of the share capital increase on December 22nd 2006, LOTOS Jasło S.A. owned 28.5% of shares in LOTOS Park Technologiczny Sp. z o.o.

In connection with the fact that the bankruptcy administrator of the Glimar Refinery published an invitation to submit declarations of interest concerning acquisition of an organised part of business of the Glimar Refinery and the Hydrokompleks unit, in Q4 the LOTOS Group conducted further analysis of the economic parameters of the asset acquisition, completion of the construction and operation of the Hydrokompleks unit.

Market Environment and Operations

In Q4 2006, the average price of Brent oil stood at USD 59.60 per barrel and was higher by 2.7 per barrel (4.7%) on the average price in the corresponding period of 2005. Compared with the market prices in Q3 2006, the oil price was down by USD 10 per barrel (14.4%). The drop in oil prices in Q4 2006 vs Q3 2006 was accompanied by a further reduction in the Ural/Brent differential, from USD 3.67 per barrel in Q4 2005 to USD 3.51 per barrel in Q4 2006 (4.4% decrease). In comparison with Q3 2006, the differential went down by 5.3%.

In connection with considerable demand for oil products, the utilisation of the LOTOS Group's refining capacities was very high in Q4 2006 at 1,583.0 thousand tonnes of oil, or 104.7% of the designed capacity. The Group refineries processed 1,332.0 thousand tonnes of Ural crude, which accounted for 84.1% of the processing volume. The balance comprised the Rozewie oil produced by Petrobaltic – 112.6 thousand tonnes (7.1% of the processing volume) and imported KUWAIT oil – 138.4 thousand tonnes (8.8% of the processing volume).

Q4 2006 saw a 43.4% drop in the average refining margin, to USD 2.96 per barrel, compared with USD 5.23 per barrel in Q3 2006. Year on year, the Q4 refining margin fell by 50.0%.

In Q4 2006, the LOTOS Group sold 450 thousand tonnes of motor gasolines, 753 thousand tonnes of diesel oil, 140 thousand tonnes of light fuel oil, 128 thousand tonnes of heavy fuel oil, 116 thousand tonnes of jet fuel, and 335 thousand tonnes of other products. In aggregate, the Group sold 1,922 thousand tonnes of petroleum products.

Compared with Q3 2006, employment at the LOTOS Group in Q4 2006 increased to 5,624 staff (79 new persons were employed). The headcount increase is mainly a result of expanded operations of LOTOS Parafiny and LOTOS Ochrona, and organisational changes in Grupa LOTOS S.A. following from implementation of the "Strategy of the LOTOS Group until 2012."

Review of the Consolidated Results of the LOTOS Group for Q4 2006

<u>Profit and Loss Account</u>

In Q4 2006, the consolidated sales revenue of the LOTOS Group reached PLN 3,156.1m and was up by 6.9% year on year. The increase was driven mainly by a 12.8% rise in sales volume. The increase in sales revenue was weaker compared to the rise in sales volume due to a 6.6% drop in the average net selling price of products and goods sold. The cost of sales reached PLN 2,741.3m in the reporting period and was up by 7.3% on Q4 2005. Despite higher crude oil prices, Q4 2006 saw a decline of USD 2.96 per barrel in the average refining margin relative to Q4 2005. As a consequence, profit on sales posted in Q4 2006 was PLN 414.9m, up by 3.9% on the corresponding period of the previous year.

The Q4 2006 selling costs rose by PLN 42.7m compared with Q4 2005 (by 29.1%) and reached PLN 189.3m. The key factors driving the increase included higher sales volume and a larger share of domestic sales in the general sales volume. The higher domestic sales volume entailed a proportionate rise in the cost of railway transport, and also in the cost of storage, since increased volumes of fuels had to be dispatched from warehouses. In Q4 2006 general and administrative expenses were up by 15.6% and reached PLN 108.8m. The increase was driven to a large extent by the expanded scope of the Group's operations.

In Q4 2006, the LOTOS Group generated operating profit of PLN 84.2m, down by PLN 53.3m on the Q4 2006 figure. The difference was further amplified by lower net cash provided by financing activities in Q4 2006, which amounted to PLN 28.1m, compared with PLN 40.9m in Q4 2005. The decrease followed mainly from recognition in 2005 of investments in UAB Naftos Gavyba.

The Q4 2006 profit before tax amounted to PLN 112.3m relative to PLN 178.4m in Q4 2005. The net profit amounted to PLN 84.2m, which means a drop by PLN 61.5m relative to the profit posted by the Group for Q4 2005. The Q4 2006 profit attributable to shareholders of the dominant entity was PLN 85.7m. The consolidated net profit of the LOTOS Group for 2006 amounted to PLN 715.2m.

<u>Balance Sheet</u>

As at December 31st 2006, total assets of the LOTOS Group were PLN 7,889.7m, up by PLN 900.1m on December 31st 2005. The increase was driven mainly by a PLN 327.0m rise in property, plant and equipment. There also occurred a PLN 274.5m rise in inventories, caused by higher prices of raw materials and larger sales volumes. The larger sales volume in turn led to a PLN 191.0m increase in trade receivables. Additionally, 2006 saw a rise in current financial assets of PLN 44.4m.

As at December 31st 2006, the Group's shareholders equity amounted to PLN 5,515.8m. The PLN 707.7m increase in equity recorded in 2006 resulted chiefly from a PLN 666.1m growth in retained earnings and a PLN 46.5m growth in minority interests.

In 2006, non-current liabilities rose slightly, by 1.9%, and amounted to PLN 729.6m as at the end of 2006. Over the twelve months of 2006, current liabilities rose by PLN 178.7m, mainly due to higher prices of oil and increased purchases, and reached PLN 1,644.3m as at the end of period.

Cash Flows

As at the end of 2006, the cash balance amounted to PLN 772.5m, having increased by PLN 4.7m relative to the end of 2005.

In Q4 2006, net cash provided by operating activities amounted to PLN 104.0m, down by PLN 21.2m on Q4 2005. The factors with a positive impact on the operating cash flows in Q4 2006 included in particular: the Q4 net profit of PLN 84.2m, depreciation/amortisation of PLN 73.0m, and a PLN 87.0m decrease in receivables. On the other hand, the key factors with a negative impact included corporate income tax paid, in the amount of PLN 61.2m, increase in inventories by PLN 85.3m as well as a PLN 52.2m decrease in liabilities and accruals and deferred income.

In Q4 2006, the LOTOS Group recorded net cash used in investing activities of PLN 308.7m (a PLN 78.5m drop year on year), driven mainly by the purchase in Q4 2006 of intangible assets as well as property, plant and equipment for PLN 197.3m, and purchase of current financial assets for PLN 108.2m.

In Q4 2006 net cash provided by financing activities amounted to PLN 66.2m, down by PLN 25.1m year on year. The positive net cash on financing activities resulted from the fact that the amount of cash provided by contracted loans and borrowings was higher than the cash used in repayment of contracted loans and borrowings.

Operating Profit/Loss of the LOTOS Group in Q4 and Q1–Q4 2006, by Business Areas

The operating activities of the LOTOS Group are divided into four business areas: exploration and production, refining and trade, retail stations, and other operations. A detailed description of the business areas is provided in the Directors' Report on the Financial Results of the LOTOS Group for Q1 2006.

The sales revenue and operating expenses of the individual business areas are presented before eliminations of transactions between business areas.

The adjustments related to the results on intra-group transactions were appropriately allocated to the business area which acts as the seller in a given transaction.

(PLNm)	Business areas							
	E&P		Refining and trade		Retail stations		Other operations	
	Q4 2006	Q1-Q4 2006	Q4 2006	Q1-Q4 2006	Q4 2006	Q1-Q4 2006	Q4 2006	Q1-Q4 2006
Sales revenue	54	377	3,113	12,644	282	1,044	100	296
Inter-area sales	*51*	*354*	*247*	*915*	*1*	*2*	*94*	*277*
External sales	*3*	*23*	*2,866*	*11,729*	*281*	*1,042*	*6*	*19*
Operating costs	(38)	(160)	(3,072)	(12,018)	(303)	(1,081)	(99)	(276)
Adjustments	49	(16)	0	1	(1)	0	(1)	(7)
Operating profit	65	201	41	627	(22)	(37)	0	13
Depreciation	13	45	55	214	1	29	3	9

Source: LOTOS Group

Exploration and Production

The Q4 2006 revenue on crude oil production was PLN 54m. Net of the operating expenses of PLN 38m and after adjustments, the operating profit amounted to PLN 65m, and earnings before interest, depreciation, income tax and amortisation (EBITDA) reached PLN 78m.

The Q4 2006 revenue generated in the production area was affected considerably by the drop of prices of light Brent oil on international markets. The prices of Brent oil are used as the basis for calculating the price of the Rozewie crude produced by Petrobaltic and purchased by the LOTOS Group. Compared with the situation in Q3 2006, in Q4 2006 the average price quoted for the Brent oil fell by about USD 10 per barrel, or 14.4%. Improvement of E&P results is attributable primarily to the fact that the Company processed the 71.4 thousand tonnes of crude oil produced by Petrobaltic which in Q2 and Q3 2006 was accumulated as inventory. Petrobaltic's actual production in Q4 2006 fell by 20.6 thousand tonnes, or 28.1%, relative to Q3 2006.

Refining – Production and trade

In Q4 2006, the refining area generated sales revenue of PLN 3,113m, operating profit of PLN 41m, and earnings before interest, depreciation, income tax and amortisation (EBITDA) of PLN 96m. The area's operating margin in Q4 2006 was 1.3%, and EBITDA margin stood at 3.1%.

The refining area's operating profit for Q4 2006 was affected to a large extent by deteriorating market conditions, such as a decrease of 4.4% in the Ural/Brent differential relative to the corresponding period of the previous year and of 5.3% relative to Q3 2006, a decline of 43.4% and 50.0% in the average refining margin compared with Q3 2006 and Q4 2005, respectively, and a drop in crack margins for nearly all key refining products compared with Q3 2006.

Retail Stations

In Q4 2006, sales revenue in the retail area amounted to PLN 282m. The area reported negative EBIT of - PLN 22m and EBITDA of PLN 1m.

The Group's weaker performance in the retail business in Q4 2006 compared with Q3 2006 was attributable mainly to the costs of restructuring and modernisation of the LOTOS Group fuel stations as well as non-recurring items, such as valuation allowances for assets and one-off benefits for employees. On the other hand, EBIT of the retail area benefited from an increase in retail margins at COCO stations, which in Q4 2006 rose on average by nearly 10% compared with Q3 2006.

As at the end of Q4 2006, the number of COCO stations was 132 (one station less than at the end of Q3 2006), the number of DOFO stations reached 57 (four stations more), and the number of DODO stations fell to 212 (one station less).

Other Operations

In Q4 2006, the sales revenue on other business was PLN 100m, the area's operating profit was PLN 0m, and EBITDA amounted to PLN 3m.

Impact of the LIFO Inventory Valuation on the Consolidated Results of the LOTOS Group in Q4 and in Q1–Q4 2006

Below we present information on the impact of the LIFO (last in, first out) inventory valuation method on the consolidated profit of the LOTOS Group for Q4 2006 and for Q1–Q4 cumulatively.

In line with its inventory valuation policies, the LOTOS Group uses the weighted average of the acquisition cost to measure decreases in inventories. This method of stock valuation defers the impact of changes in oil prices on the prices of finished products. Thus, an increase in oil prices on the global market has a positive effect on the financial performance of the Group, while a decrease drives it down. The operating profit accounting for the impact of this valuation method is presented as item 1 in the table below.

The consolidated operating profit of the LOTOS Group for Q4 2006 and Q1–Q4 2006 accounting for the estimated impact of using the LIFO method for inventory valuation (along with the comparable data for Q4 2005 and Q1–Q4 2005) is presented as item 2.

No.	(PLNm)	Q4 2006	Q4 2005	Change	Q1-Q4 2006	Q1-Q4 2005	Change
1.	**Operating profit**	84.2	137.5	(38.8%)	804.3	1,069.9	(24.8%)
2.	**Operating profit – LIFO method**	253.4	168.1	50.8%	937.3	785.6	19.3%
3.	**Operating profit – LIFO method** (adjusted for negative goodwill)	253.4	168.1	50.8%	937.3	519.0	80.6%

Source: LOTOS Group

When analysing the LOTOS Group's financial performance with the inventory valuated using the LIFO method, it should be emphasised that the operating profit improved both on cumulative and quarter-to-quarter basis. Relative to the corresponding period of 2005, the Q4 2006 operating profit rose by 50.8%, to PLN 253.4m. On a cumulative basis, the operating profit posted by the LOTOS Group increased by 19.3%, reaching PLN 937.3m.

It should be noted that the Q1–Q4 2005 results (i.e. the operating profit calculated using the weighted average of the acquisition cost and the LIFO method) strongly benefited from the recognition of negative goodwill of PLN 266.6m (connected with the purchase of shares in the Southern Refineries and Petrobaltic on February 3rd 2005) in Q1 2005, which increased the operating profit. If the negative goodwill was deducted from the Q1–Q4 2005 operating profit, a comparison of this profit with the Q1–Q4 2006 cumulative operating profit would show that the Company actually increased its operating profit by PLN 418.3m, or 80.6%.

The assumptions made in calculating the Q4 2006 and Q1–Q4 2006 operating profit of the LOTOS Group accounting for the estimated impact of using the LIFO method for inventory valuation (along with the comparable data for Q4 2005 and Q1–Q4 2005) are described in Current Report No. 29/2006.