THE LOTOS GROUP

DIRECTORS' REPORT ON THE FINANCIAL RESULTS OF THE LOTOS GROUP

IN Q3 2006

Gdańsk, November 14th 2006

Introduction

In Q3 2006, the activities of the Management Board of Grupa LOTOS S.A. focused on optimal utilisation of the LOTOS Group's E&P assets, maximising utilisation of production capacity, and further strengthening of the Company's market position. These activities, contributing to building shareholder value, were pursued as part of the development programme for oil production and supply, the Comprehensive Technical Upgrade Programme (the PKRT Project), the PROSTA Programme, and the trading development and optimisation programme.

As concerns the PKRT Project, efforts in Q3 2006 focused on its further technological development and selecting contractors for the implementation of investment tasks under the Project. Based on the existing Basic Design, a two-stage tender was carried out for the construction of the diesel oil hydrodesulphurisation (HDS) unit. The process of selecting contractors has been completed and contract negotiations are currently in progress. Steps were also taken towards commencing the construction of the new crude distillation unit (CDU). The contract for preparing the Basic Design for the CDU unit was signed with Uhde Edeleanu. With respect to the upgrade of the existing hydrocracking unit, the contract for preparation of the Basic Design was signed with Chevron Lummus Global.

With regards to the PROSTA Programme, the Group continued activities aimed at building a modern nationwide network of LOTOS service stations and concentrated on continued development of the COCO and DOFO stations network, as well as on rebranding work. As at the end of September 2006, the LOTOS service stations network comprised 399 stations, 133 of which were owned by the LOTOS Group.

As for the Southern Refineries, in Q3 2006 the Group carried on restructuring efforts, particularly in the area of auxiliary activities, adapting LOTOS Czechowice and LOTOS Jasło to operations within the LOTOS Group. LOTOS Biopaliwa (a subsidiary of LOTOS Czechowice) continued, according to schedule, construction of a unit for the production of methyl esters of fatty acids (FAME) used as a biodiesel additive.

Q3 2006 was a period of significant deterioration of market conditions, particularly those affecting the oil refining business. The average price of Brent crude oil was similar to Q2 2006 and stood at USD 69.60/bbl. The stabilisation of oil prices in Q3 2006 was accompanied by a significant drop in the Ural/Brent differential, from USD 4.51/bbl in Q3 2005 to USD 3.70/bbl in Q3 2006 (an 18% decrease). In comparison with Q2 2006, the differential decreased by 24.2%. In Q3 2006, the average refining margin fell by 23.1%, to USD 5.23/bbl, versus USD 6.80/bbl in Q2 2006. The Q3 2006 refining margin fell by 32.5% year on year. Thanks to strong demand for petroleum products, capacity utilisation was very high. It exceeded nameplate refining capacity and reached a capacity utilisation rate of over 104%.

The financial performance of the LOTOS Group in Q3 2006 weakened in comparison with the corresponding period of 2005. Although net sales revenue went up by 21.0% and reached PLN 3,701.8m, operating profit fell by PLN 214.5m, to PLN 254.5m, while net profit attributable to the parent undertaking's shareholders (i.e. net of minority interests) was PLN 199.6m, down by 47.6%.

In the first three quarters of 2006, consolidated sales revenue of the LOTOS Group amounted to PLN 9,656.6m, operating profit was PLN 720.1m, net profit stood at PLN 631.0m and net profit attributable to the parent undertaking's shareholders was PLN 580.5m. Compared with the corresponding period of 2005, sales revenue went up by 44.3%, while operating profit, net profit and net profit attributable to the parent undertaking's shareholders fell by 22.8%, 23.3%, and 26.3%, respectively. The factor which had a decisive effect on the financial performance as compared with the corresponding period of the previous year was PLN 266.6m of negative goodwill (relating to the recognition of an excess of the share in the net assets over the acquisition cost of the Southern Refineries and Petrobaltic acquired on February 3rd 2005), which drove up the Q1 2005 operating profit. If the negative goodwill recognition is taken into account and the Company's financial results in the first nine months of 2005 are adjusted for its impact and compared with the results in the first three quarters of 2006, it turns out that operating profit for Q1-Q3 2006 increased by PLN 54.3m (8.2%), while net profit rose by PLN 74.5m (13.4%).

Even more favourable is the comparison of the Company's performance with the LIFO method applied to inventory valuation, both on a cumulative and quarter-on-quarter basis. Compared with the corresponding period in 2005, the Q3 2006 operating profit rose by 5.7%, to PLN 318.5m, and the cumulative operating profit went up by 10.7%, reaching PLN 683.9m. After adjusting the LIFO Q1-Q3 2005 operating result for the negative goodwill described above and comparing it with the cumulative operating result generated after the three quarters of 2006, it turns out that the Company's operating profit increased by PLN 332.9m, i.e. by 94.8%.

Comprehensive Technical Upgrade Programme

As concerns the execution of the Comprehensive Technical Upgrade Programme (PKRT Project), which is the Company's largest investment project of key importance for future growth of its value, the activities pursued by the Company in Q3 2006 focused on further work on its technological development and selection of contractors for the implementation of investment tasks under the Project.

In Q2 2006, the Project's scope was extended and Q3 2006 saw the Group commence the process of selecting contractors for individual units to be constructed under the PKRT Project (IGCC, MHC and ROSE).

Based on the existing Basic Design, a two-stage tender was carried out for the construction of the diesel oil HDS unit. The full scope of the work comprises the technical design, deliveries and unit construction. The contractor selection process has been completed and contract negotiations are currently in progress. The HDS unit will be constructed under a licence from Chevron Lummus Global. The construction of this unit will enable the Group to meet the quality requirements which are to apply to diesel fuel as of 2009 (sulphur content of 10 ppm).

In Q3 2006, we also took steps with a view to commencing the construction of a new CDU unit. The contract for preparing the Basic Design for the CDU unit was signed with Uhde Edeleanu. Following construction of the CDU unit, the oil throughput in the Gdańsk refinery of the LOTOS Group will increase to 10.5m tonnes per annum in 2010 and the Company will not have to depend on imports of additional feedstock for the PKRT units.

As concerns the upgrade of the existing hydrocracking unit, in Q3 2006 a contract for the preparation of the Basic Design was signed with Chevron Lummus Global.

Furthermore, an tender was organised for the "over-the-fence" construction of an air separation unit (ASU). The terms and conditions of the contract are currently under negotiation.

Following the Supervisor Board's decision made in Q2 2006, concerning the delivery of four reactors for the MHC unit as part of the PKRT Project, the orders for the reactors were executed. The launch of construction of the reactors is a milestone in the PKRT Project implementation schedule.

After the FEED-PB agreement with Fluor and the UHDE/Technip consortium was signed in the first quarter of 2006, the second and third quarter was a time of intensive work on the development of the Front End Engineering Design for the PKRT Project and on drawing up proposals for realisation of the Project by the two companies.

Preparatory work on the construction site located on the Gdańsk refinery grounds was initiated. The work includes soil survey, soil removal, ground levelling, draining, demolition and removal of structures from the construction site, providing electricity to the site, and building temporary roads. Furthermore, efforts were undertaken to work out the scope and form of insurance for unit construction under the entire project and to arrange for such insurance.

PROSTA Programme

The Company's activities in Q3 2006 related to the development of a retail fuel distribution network, pursued by the subsidiary undertaking LOTOS Paliwa as part of the PROSTA Programme, focused on continued expansion of the COCO stations network, rebranding work, and expansion of the DOFO network.

In the reporting period, investment projects commenced in the previous quarter were continued. The Group opened a service station in Tychy, started the construction work on two other COCO stations (in Rzeszów and Katowice), started a comprehensive programme of installing LPG modules at service stations purchased from ESSO and Slovnaft, rebranded 26 stations throughout Poland, and added three new stations to the LOTOS Family Commercial Partnership Programme.

Q3 2006 saw the commencement of disinvestment processes aimed at optimising the structure of the service stations network and rationalising the real estate assets. Moreover, the Investment Division was removed from the structures of LOTOS Paliwa and its technical and investment functions were transferred to a specialist company LOTOS Serwis.

As at September 30th 2006, the LOTOS network comprised 399 service stations, including 133 COCO stations, 53 DOFO stations and 213 DODO stations.

Petrobaltic and Production Activities

In Q3 2006, Petrobaltic continued test production on the B-8 oil field, producing over 18.4 thousand tonnes of crude oil. In Q3 2006, the production from the B-3 and B-8 oil fields totalled over 73.4 thousand tonnes of crude oil. All of the crude oil produced in Q3 was sent to the refinery in Gdańsk.

Southern Refineries (LOTOS Czechowice and LOTOS Jasło)

In Q3 2006, further restructuring work was carried out to adapt LOTOS Jasło and LOTOS Czechowice to operating within the LOTOS Group.

In Q3 2006, LOTOS Biopaliwa Sp. z o.o., a subsidiary of LOTOS Czechowice established to carry out an investment project consisting of the construction of a plant for the production of methyl esters of fatty acids (FAME) used as biodiesel additives, continued the project implementation, as scheduled. On June 30th 2006, after fulfilment of conditions precedent, the agreement with the contractor came into force and design work was begun. In line with the assumptions related to the project's financing, LOTOS Biopaliwa took steps aimed at obtaining external financing in the form of a loan. As a result of those efforts, as at the end of August the company had received four proposals from banks interested in participating in this project. At the end of September, a special team selected the best proposals and recommended that negotiations should be held with a view to executing a relevant agreement.

In August, the bankruptcy administrator of the Glimar Refinery published in the press an invitation to submit declarations of interest concerning acquisition of an organised part of business of the Glimar Refinery, including the Hydrocomplex unit. The LOTOS Group expressed its interest in participating in the due diligence of the assets offered for sale. A dedicated team started an analysis of the economic parameters of the asset acquisition, completion of the construction and operation of the Hydrocomplex unit.

Market Environment and Operations

Q3 2006 was a period of significant deterioration of market conditions, particularly those affecting the refining business. As concerns the oil production business, Q3 2006 was similar to Q2 2006. The average price of Brent crude oil stood at USD 69.60/bbl and was 12.8% higher than in Q3 2005. Compared with Q2 2006, the crude oil price remained at the same level. Stabilisation of oil prices in Q3 2006 was accompanied by a sharp drop in the Ural/Brent differential, from USD 4.51/bbl in Q3 2005 to USD 3.70/bbl in Q3 2006 (an 18% decrease). In comparison with Q2 2006, the differential went down by 24.2%.

Q3 2006 saw a 23.1% drop in the average refining margin, to USD 5.23/bbl, compared with USD 6.80/bbl in Q2 2006. Year on year, the Q3 refining margin fell by 32.5%. The crack margins for nearly all the key oil products decreased in Q3 2006 relative to Q2 2006. The crack margin for gasoline dropped by 16.5%, for light fuel oil – by 2.0%, and for heavy fuel oil – by 6.4%. Over the same period, the margin for diesel oil remained the same and rose by 3.3% in the case of jet fuel. Compared with Q3 2005, Q3 2006 saw a decrease in crack margins for gasoline, diesel oil, and light and heavy fuel oil, by 7.1%, 10.2%, 10.0% and 12.0%, respectively, while the crack margin for jet fuel increased by 2.3%.

In Q3 2006, the Gdańsk Refinery processed 1,577.7 thousand tonnes of oil, thus reaching 104.3% of its nameplate refining capacity. The refinery processed 516.9 thousand tonnes of Ural crude, which accounted for 96.1% of total crude oil processed by the refinery. The balance was comprised of Rozewie crude oil produced by Petrobaltic – 42.3 thousand tonnes (2.7% of the processing volume) and imported SLEIPNER oil condensate – 18.5 thousand tonnes (1.2% of the processing volume). In Q3 2006, the LOTOS Group sold 412 thousand tonnes of motor gasolines, 678 thousand tonnes of diesel oil, 112 thousand tonnes of light fuel oil, 77 thousand tonnes of heavy fuel oil, 143 thousand tonnes of jet fuel, and 408 thousand tonnes of other products.

Compared with Q2 2006, employment at the LOTOS Group in Q3 2006 slightly decreased – to 5,545 staff (a decrease of 2 persons).

Review of the Consolidated Results of the LOTOS Group for Q3 2006

Profit and Loss Account

In Q3 2006, the consolidated sales revenue of the LOTOS Group reached PLN 3,701.8m and was up by 21.0% on Q3 2005. The increase was driven mainly by a 7.8% rise in sales volumes and higher unit selling prices. The cost of sales stood at PLN 3,204.8m, having gone up by 34.2% on Q3 2005. Q3 2006 was marked by high prices of oil and oil products and lower margins for key refining products. As a consequence of the above operating and market conditions, in Q3 2006 the LOTOS Group posted profit on sales of PLN 497.0m, which represents a 26.0% decrease on Q3 2005.

The Q3 2006 selling costs rose to PLN 185.1m, i.e. by 21.2% over Q3 2005, mainly due to higher sales volumes. During the period, the LOTOS Group generated operating profit of PLN 254.5m, down by 45.7% on the Q3 2005 figure. The difference between the Q3 2006 and Q3 2005 results was additionally amplified by lower cash flows provided by financing activities, which amounted to PLN 19.7m, compared with PLN 28.9m in Q3 2005.

The Q3 2006 profit before tax amounted to PLN 274.2m, and was 45.0% lower year on year. The net profit amounted to PLN 216.8m, which represents a fall of PLN 188.7m relative to Q3 2005. The Q3 2006 profit of the parent undertaking's shareholders was PLN 199.6m.

The consolidated net profit of the LOTOS Group for the first nine months of 2006 amounted to PLN 631.0m.

Balance Sheet

As at September 30th 2006, the balance-sheet total of the LOTOS Group was PLN 7,823.2m, up by PLN 833.6m from 31 December 2005. The increase was driven mainly by a PLN 230.2m rise in property, plant and equipment, higher prices of raw materials and products, and higher sales volume, resulting in a PLN 280.9m increase in trade receivables and a PLN 189.2m rise in inventories. Relative to the end of 2005, cash and cash equivalents rose by PLN 143.1m, principally due to cash flows provided by operating activities. At the same time, current financial assets declined by PLN 55.3m compared to the end of 2005.

As at 30 September 2006, shareholders equity amounted to PLN 5,435.1m. The PLN 627.0m increase in shareholders equity recorded in the first three quarters of 2006 resulted primarily from a PLN 580.5m growth in retained earnings and minority interests higher by PLN 48.1m.

Non-current liabilities dropped slightly by 2.4% in the first nine months of 2006, amounting to PLN 698.5m as at the end of September 2006.

As at the end of Q3 2006, current liabilities reached PLN 1,689.7m and rose PLN 224.1m over the first three months of 2006, mainly due to higher prices of oil and oil products as well as increased sales volumes.

Cash Flows

As at the end of Q3 2006, the cash balance amounted to PLN 910.9m, having increased by 128.6m relative to the end of Q3 2005.

In Q3 2006, net cash provided by operating activities amounted to PLN 251.7m, up by PLN 67.7m on the amount of net cash provided by operating activities in Q3 2005. Cash provided by operating activities in Q3 2006 comprised principally the net profit of PLN 216.8m generated in Q3 and Q3 depreciation/amortisation of PLN 76.4m.

In Q3 2006, the Group recorded net cash used in investing activities of PLN 185.4m. Cash flows from investing activities fell by PLN 244.8m relative to Q3 2005, when it stood at PLN 59.4m. The substantial difference between net investing cash flows in Q3 of the current and previous year was caused by significant spending on current financial assets in Q3 2006 and gains on the sale of current financial assets in Q3 2005.

In Q3 2006, the LOTOS Group generated PLN 18.0m of cash flows provided by financing activities (related mainly to contracted loans and borrowings). In Q3 2005, the Group recorded cash flows used in financing activities in the amount of PLN 22.2m, resulting mainly from a higher amount of loans and borrowings repaid than contracted.

Operating Profit/Loss of the LOTOS Group in Q3 and Q1–Q3 2006, by Business Areas

The operating activities of the LOTOS Group are divided into four business areas: crude oil production, refining and marketing, retail network, and other business. A detailed description of the business areas is provided in the Directors' Report on the Financial Results of the LOTOS Group in 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							
	Crude oil production		Refining and marketing		Retail		Other business	
	Q3 2006	Q1-Q3 2006	Q3 2006	Q1-Q3 2006	Q3 2006	Q1-Q3 2006	Q3 2006	Q1-Q3 2006
Sales revenue	117	323	3,644	9,531	298	762	65	196
Inter-area sales	*(104)*	*(303)*	*(255)*	*(668)*	*0*	*(1)*	*(65)*	*(183)*
External sales	*13*	*20*	*3,389*	*8,863*	*298*	*761*	*3*	*13*
Operating expenses	(42)	(122)	(3,447)	(8,946)	(293)	(778)	(62)	(177)
Adjustments	(28)	(65)	2	1	0	1	(2)	(6)
Operating profit	47	136	199	586	5	(15)	4	13
Amortisation and depreciation	11	32	53	159	11	28	2	6

Source: LOTOS Group

Crude Oil Production

The Q3 2006 revenue on crude oil production was PLN 117m. Net of the operating expenses of PLN 42m and after adjustments, the operating profit amounted to PLN 47m, and earnings before interest, depreciation, income tax and amortization (EBITDA) reached PLN 58m.

The material driver of Q3 2006 revenue generated in the production area was the consistently high level of Brent crude oil prices on international markets. The prices of light Brent crude oil provide the basis for calculation of the price of Rozewie crude produced by Petrobaltic and purchased by the LOTOS Group. Compared to the situation in Q2 2006, in Q3 2006 the average price quoted for the Brent crude oil did not change and was USD 69.60/bbl. Compared to Q3 2005, the price of Brent crude increased by 12.8%. The Q3 2006 results of the crude oil production business were significantly affected by the fact that despite the increase in Petrobaltic's crude oil production to 73.4 thousand tonnes a significant portion of the crude oil produced by Petrobaltic was stored by the LOTOS Group to be processed in winter. This resulted in an adjustment to a portion of the margin of the upstream area in Q3 2006. Petrobaltic's actual production in Q3 2006 rose by 28.8% relative to the corresponding period of 2005.

Refining – Production and Marketing

In Q3 2006, the refining area generated sales revenue of PLN 3,644m, operating profit of PLN 199m, and earnings before interest, depreciation, income tax and amortization (EBITDA) of PLN 252m. The area's operating margin in Q3 2006 was 5.5%, while the EBITDA margin was 6.9%.

The refining area's operating profit for Q3 2006 was affected to a large extent by deteriorating market conditions, such as a decrease by 18.0% in the Ural/Brent differential relative to the corresponding period of the previous year and by 24.2% relative to Q2 2006, a decline by 23.1% and 32.5% in the average refining margin compared with Q2 2006 and Q3 2005, respectively, and a drop in crack margins for nearly all key refining products compared to Q2 2006.

Important factors with a positive impact on the refining area's performance in Q3 2006 included the high utilisation rate of the refining capacity and the favourable product portfolio structure. Due to the significant demand for oil products, in Q3 2006 the LOTOS Group sold record volumes of refining products, reaching 1,830.0 thousand tonnes, while the utilisation of the designed processing capacity (6m tonnes annually) reached 104.3% (the Gdańsk Refinery processed 1,577.7 thousand tonnes of oil). The summer season was particularly favourable for optimisation of the product portfolio, both in volume and value terms. In volume terms, in Q3 2006, compared with Q2 2006, there was an 11.1% growth in sales of motor gasolines, an 8.8% growth in sales of diesel oil, a 25.8% growth in sales of light fuel oil, and a 31.2% increase in sales of jet fuel oil, with a concurrent substantial decline of 43.4% in sales of heavy fuel oil.

Retail Operations (Service Stations Network)

In Q3 2006, sales revenue in the retail area amounted to PLN 298m. The area reported operating profit of PLN 5m and EBITDA of PLN 16m.

The retail area's operating profit was significantly benefited by retail margins at COCO stations, which increased by 25.5% in comparison with Q2 2006, and by 11.5% compared to Q3 2005. In Q3 2006, the average annual throughput was 2.6m litres at COCO stations and 1.6m litres at DOFO stations.

The good financial performance in the retail area in Q3 2006 is attributable primarily to taking advantage of the opportunities created by favourable market conditions and to the disposal of redundant assets held for sale. Q3 2006 was also a time of continued restructuring and upgrading work at the LOTOS service stations (the rebranding of the ESSO and Slovnaft stations and preparation of loyalty programmes), which had a bearing on the Company's financial performance.

As at the end of Q3 2006, the number of COCO stations was 133 (one station more than at the end of Q2 2006), the number of DOFO stations reached 53 (three stations more), and the number of DODO stations fell to 213 (eight stations less).

Other Business

In Q3 2006, the sales revenue on other business reached PLN 68.0m, the area's operating profit was PLN 4.0m, and EBITDA amounted to PLN 6.0m.

Impact of the LIFO Inventory Valuation on the Consolidated Results of the LOTOS Group in Q3 and in Q1–Q3 Cumulatively

Information on the impact of the LIFO (last in, first out) inventory valuation method on the consolidated profit of the LOTOS Group for Q3 2006 and for cumulative Q1–Q3 is presented below.

In line with its inventory valuation policies, the LOTOS Group uses the weighted average of the acquisition cost to measure utilisation of inventories. This method of inventory valuation defers the effects of changes in crude oil prices relative to the prices of finished products. Thus, an increase in oil prices on the global market has a positive impact on the financial performance of the Group, while a decrease has a negative impact. 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 Q3 2006 and Q1–Q3 2006 accounting for the estimated impact of using the LIFO method for inventory valuation (along with the comparable data for Q3 2005 and Q1–Q3 2005) is presented as item 2.

No.	(PLNm)	Q3 2006	Q3 2005	Change	Q1–Q3 2006	Q1–Q3 2005	Change
1.	**Operating profit**	254.5	469.0	(45.7%)	720.1	932.4	(22.8%)
2.	**LIFO operating profit**	318.5	301.5	5.7%	683.9	617.6	10.7%
3.	**LIFO operating profit** (adjusted for negative goodwill)	318.5	301.5	5.7%	683.9	351.0	94.8%

Source: LOTOS Group

When analysing the LOTOS Group's financial performance with inventory valuation using the LIFO method, it should be emphasised that the operating profit improved both on a cumulative and quarter-to-quarter basis. Relative to the corresponding period of 2005, the Q3 2006 operating profit rose by 5.7%, to PLN 318.5m. On a cumulative basis, the operating profit posted by the LOTOS Group was up by 10.7%, reaching PLN 683.9m. It should be noted that the Q1-Q3 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 operating profit. If the negative goodwill were deducted from the Q1–Q3 2005 operating profit, a comparison of this profit with the Q1–Q3 2006 cumulative operating profit would show that the Company actually increased its operating profit by PLN 332.9m, or 94.8%.

The assumptions made in calculating the Q3 2006 and Q1–Q3 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 Q3 2005 and Q1–Q3 2005) are described in Current Report No. 29/2006.