THE LOTOS GROUP

DIRECTORS' REPORT ON THE FINANCIAL RESULTS OF THE LOTOS GROUP

IN Q1 2006

Gdańsk, May 15th 2006

Introduction

In Q1 2006, the activities of the Management Board of the Company focused on execution of the key development projects presented to the investors during the public offering, including the Comprehensive Technical Upgrade Programme (PKRT), the PROSTA Service Station Network Development Programme, as well as the restructuring and development of the Southern Refineries' assets.

As concerns the PKRT Project, our efforts focused on further work on technical development, negotiating agreements related to various aspects of the Project, and relations with selected financial institutions. In particular, base designs for the key units were provided by the licensors, and contractors for the base integrative design were selected. As regards execution of the PROSTA Programme, the activities aimed at building a modern nation-wide network of LOTOS service stations concentrated on continued development of the CODO stations network and on incorporation of the acquired ESSO and Slovnaft stations into the LOTOS network. As for the Southern Refineries, in Q1 2006, the Company carried on restructuring activities to streamline the capital and organisational structure of the Group in southern Poland, particularly with respect to the auxiliary activities and oil operations.

In Q1 2006, the average price of Brent oil stood at USD 61.74/bbl, having gone up by 29.4% year on year. Compared with Q4 2005, in Q1 2006 the price grew by 8.5%. The rise went hand in hand with a decline in Ural/Brent differential from USD 5.09/bbl in Q1 2005 to USD 3.64/bbl in Q1 2006. In comparison with Q4 2005, the differential was reduced by 1%. The capacity utilisation at the Company was high and reached nearly 95%.

Net sales revenue went up by 81.0% compared with the corresponding period of the previous year, and amounted to PLN 2,689.6m. Due to the recognition of PLN 266.6m negative goodwill (relating to the acquisition of shares in the Southern Refineries and Petrobaltic on February 3rd 2005), which drove the operating profit up, the base for comparison is very high. Thus, even though the revenue grew significantly in Q1 2006, the financial results of the LOTOS Group were weaker than in Q1 2005. The operating profit went down by 62.8% to PLN 130.7m, while the net profit (net of the profit attributable to minority interests) dropped by 67.9% to PLN 102.9m. A comparison of the Company's Q1 2005 financial results adjusted for the impact of the negative goodwill recognition with the Q1 2006 figures shows that the operating profit for Q1 2006 increased by PLN 45.8m (54.0%), while the net profit went up by PLN 48.9m (90.6%).

Comprehensive Technical Upgrade Programme

As concerns execution of the Comprehensive Technological Upgrade Programme (PKRT Project), which is of key importance for the Company's development and future growth of shareholder value, activities pursued by the Company in Q1 2006 were focused on further technical development work, negotiations of contracts relating to various areas of the Project and on contacts with selected financial institutions.

In Q1 2006, the licensors of three main technologies of the Project, namely Shell Global Solutions and KBR, continued design work aimed at developing base designs of the main units to be constructed as part of the Project. The work was completed at the end of January and the beginning of February 2006. The base design of the ROSE unit was delivered by KBR in January, and the base designs of the MHC and IGCC units were provided by SGSI in February 2006.

When the time-consuming work conducted by the tender committee in 2005 was completed and following the negotiations with the short-listed bidders (i.e. Fluor and the UHDE/Technip consortium), on January 31st 2006 the terms and conditions of co-operation were agreed upon and the agreements on preparation of the base integrative design for the Project and on provision of engineering services related to the Project development (FEED-PB Agreement) were signed.

The FEED-PB Agreement provides for the following two main stages:

- Preliminary Technical Design – project coordination, communication, management, drafting the project documentation, and estimation of costs on the basis of indicative offers from the key suppliers; and

- Base Design – engineering work comprising designs of units which do not require a licence and preparation of documents for the integrative base design of all the project work.

A summary Information Memorandum concerning the Project was prepared for commercial banks and distributed on January 24th 2006. Several commercial banks expressed their preliminary interest in the Project funding. Based on their response, further activities are undertaken with a view to arranging debt financing of the Project by commercial banks.

In Q1 2006, together with BNP Paribas, our financial advisor, we continued work on the PKRT financial model, which will be a basis for formal invitations to selected financial institution to submit their PKRT financing proposals. The invitations are to be sent in Q3 2006.

In Q1 2006, we also worked on preparing applications for subsidies under the Sector Operational Programme – Enhancement of Companies' Competitiveness. The work was completed with filing two applications with the Polish National Fund for Environmental Protection in March 2006. In the applications we requested financial support for a project whose objective is to adjust our enterprise to the environmental requirements concerning investments necessary to obtain the integrated permit as well as air protection requirements.

Q1 2006 saw also the close of negotiations with STASCO on a contract for supplies of supplementary feedstock for the PKRT Project units. The contract was signed on April 11th 2006.

PROSTA Programme

The Company's activities in Q1 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 own service stations, in particular by incorporating the ESSO and Slovnaft service stations, acquired in 2005, into the LOTOS network, and by expanding the DOFO network.

On March 9th 2006, we executed the final agreement on the purchase of Slovnaft Polska S.A.'s organised part of business comprising in particular 12 own stations located in southern Poland, a region of strategic importance for the development of the LOTOS network, and 2 undeveloped plots for new service stations.

In the reporting period, the Company proceeded with consolidating the ESSO and Slovnaft stations with the LOTOS network. As at March 31st 2006, 38 ESSO stations and one Slovnaft station were incorporated into the network, whereas the remaining stations were considered not yet ready to operate under the LOTOS brand. Since the acquisition, rebranding work has been carried out at the stations.

In Q1, five new DOFO stations were added to the LOTOS network.

As at March 31st 2006, the LOTOS network comprised 406 stations, of which 131 were CODO, 225 DODO, and 50 DOFO stations.

Petrobaltic and Production Activities

In Q1 2006, Petrobaltic, an upstream company, started trial mining on the B-8 deposit and produced over 12.1 thousand tonnes of crude oil. The production from the B-3 and B-8 deposits totalled over 65.3 thousand tonnes of crude oil in Q1 2006, all of which was supplied as feedstock to the refinery in Czechowice-Dziedzice.

Southern Refineries

In Q1 2006, restructuring activities were continued to streamline the capital and organisational structure of the Group in southern Poland.

In connection with the restructuring of the Southern Refineries, the share capital of LOTOS Park Technologiczny Sp. z o.o., a key company in the restructuring of the LOTOS Group's assets located in the south of Poland, was increased twice in Q1 2006. New issue shares were delivered in exchange for a contribution in kind and a cash contribution, and were acquired by LOTOS Czechowice S.A. and Grupa LOTOS S.A. The increased share capital of LOTOS Park Technologiczny is divided into 24,748 shares, of which 24,648 are held by the LOTOS Group, and the remaining 100 belong to Kolaja&Partners Sp. z o.o., which is involved in the restructuring of the assets.

As regards consolidation of the maintenance activities, in Q1 2006 LOTOS Serwis Sp. z o.o. acquired 100% of shares in Monto-Rem Sp. z o.o. and 100% of shares in RC REMO Sp. z o.o. Both transactions were effected on January 5th 2006 and were preceded by the purchase of a minority interest in Monto-Rem by LOTOS Jasło S.A. Efforts are under way to incorporate the acquired companies into LOTOS Serwis.

Furthermore, as part of the restructuring of the production and sale of oils, on January 2nd 2006 LOTOS Oil S.A. acquired production assets from LOTOS Czechowice.

Market Environment and Operations

In Q1 2006 the average price of Brent oil stood at USD 61.74/bbl, and was up on the previous year figure by 29.4%. Compared with Q4 2005, the oil price grew by 8.5%. The rise was accompanied by a falling Ural/Brent differential, resulting from lower supply of Ural due to difficult weather conditions, in particular the harsh winter which hindered loading of tankers in the port in Novorossijsk, and problems with passage through the Bosphorus Strait. The Ural/Brent differential went down from USD 5.09/bbl in Q1 2005 to USD 3.64/bbl in Q1 2006. Compared with Q4 2005, the decrease was insignificant and amounted to 1%.

The equilibrium restored on the oil and oil derivative products market in Q4 2005 was followed by further seasonal fall in demand, which brought about a decrease in the Q1 2006 average refining margin to USD 4.12/bbl, compared with USD 5.92/bbl in Q4 2005. At the same time the Q1 refining margin increased by USD 1.21/bbl year on year. Compared with Q4 2005, the crack margins for all the key oil products declined in Q1 2006. Crack margins for gasoline fell by 4.3%, for diesel oil – by 22.7%, for light fuel oil – by 21.7%, and for jet fuel – by 8.9%. Compared with Q1 2005, Q1 2006 saw an increase in crack margins for gasolines, light fuel oil, and jet fuel, by 24.9%, 7.7% and 14.9%, respectively, while the crack margin for diesel oil decreased by 10.6%.

In Q1 2006, the Gdańsk Refinery processed 1,400.3 thousand tonnes of oil, thus reaching 94.6% of its installed capacity. 100% of the distilled oil was Ural Brent. All of the Rozewie oil extracted by Petrobaltic was supplied to the refinery in Czechowice-Dziedzice. In Q1 2006, the LOTOS Group sold 363 thousand tonnes of motor gasolines, 503 thousand tonnes of diesel oil, 144 thousand tonnes of light fuel oil, 397 thousand tonnes of heavy fuel oil, and 81 thousand tonnes of jet fuel.

Compared with Q4 2005, in Q1 2006 the employment in the LOTOS Group rose by 66 persons, up to 5,501 staff. The increase resulted from the service station network development carried out by LOTOS Paliwa, and an increase in the number of employees in the LOTOS Group Production Division, related to a planned change in the organisation of working time, as well as from business expansion by LOTOS Parafiny.

Review of the Consolidated Results of the LOTOS Group for Q1 2006

<u>Profit and Loss Account</u>

In Q1 2006, the consolidated sales revenue of the LOTOS Group was up by 81.0% on Q1 2005, and amounted to PLN 2,689.6m. The increase was driven mainly by higher sales volume reported by the Group and higher unit selling prices. The cost of sales in Q1 2006 stood at 2,348.2m, having gone up by 85.2% on the 2005 figure. As a result, the net profit on sales in Q1 2006 rose by 56.7% from the Q1 2005 figure and totalled PLN 341.4m.

The Q1 2006 consolidated operating profit stood at PLN 130.7m, down by PLN 220.8m, or 62.8%, from Q1 2005. The main driving force behind the decline was the negative goodwill of PLN 266.6m, which increased the Q1 2005 operating profit and was related to the recognition of an excess of the Company's share in the net assets of the Southern Refineries and Petrobaltic (acquired on February 3rd 2005) over their acquisition cost. Simultaneously, the selling costs in Q1 2006 were up by PLN 64.5m on Q1 2005, due to higher sales volume.

The Q1 2006 profit before tax amounted to PLN 149.8m, which represents a decline by PLN 201.8m (57.4%) year on year. The Q1 2006 profit before tax was driven up by the PLN 19.2m positive balance on the financing activities, compared with a negative balance of PLN 2.1m in Q1 2005.

Due to the above-mentioned difference resulting from the recognition of negative goodwill in the base period (i.e. in Q1 2005), the Q1 2006 net profit (net of profit attributable to minority interests) went down by 67.9% to PLN 102.9m.

The negative goodwill recognition described above benefited considerably the consolidated financial results of the LOTOS Group for Q1 2005, thus establishing a very high base. A comparison of the Company's Q1 2005 financial results adjusted for the impact of the negative goodwill recognition with the Q1 2006 figures shows that the operating profit grew in Q1 2006 by PLN 45.8m (54.0%), and the net profit went up by PLN 48.9m (90.6%).

Balance Sheet

As at March 31st 2006, the balance-sheet total for the LOTOS Group was PLN 7,064.4m, up by PLN 74.8m on December 31st 2005.

The increase was driven by a PLN 118.4m rise in property, plant and equipment, a PLN 60.0m increase in inventories, attributable to higher prices of raw materials and products, and a PLN 186.8m growth in trade receivables. Simultaneously, cash and current financial assets declined by PLN 312.5m.

As at March 31st 2006, the equity amounted to PLN 4,926.8m. The nearly PLN 120,0m increase in equity resulted chiefly from a PLN 102.9 growth in retained earnings and a PLN 14.7m growth in minority interests.

Non-current liabilities rose slightly in Q1 2006 to PLN 734.3m as at the end of March 2006. Concurrently, current liabilities in Q1 2006 fell by PLN 62.3m to PLN 1,403.3m.

Cash Flows

As at the end of Q1 2006, cash amounted to PLN 577.1m, having increased by PLN 294.7m relative to the balance as at the end of Q1 2005 .

Net cash used in operating activities in Q1 2006 amounted to PLN 91.4m, down by PLN 109.7m on the net cash provided by operating activities in Q1 2005. The decrease was driven primarily by a rise in receivables of nearly PLN 199.9m (relative to a PLN 122.9m fall in receivables reported in Q1 2005), and the higher corporate income tax paid (up by PLN 71.4m).

In Q1 2006, the LOTOS Group reported PLN 161.9m of net cash used in investing activities (down by PLN 177.9m relative to PLN 16.0m reported in Q1 2005). The negative balance was caused mainly by expenditure on tangible and intangible assets, was higher by PLN 75.7m in Q1 2006 than in Q1 2005.

In Q1 2006, financing activities provided net cash of PLN 62.6m (down by PLN 29.3m on the corresponding period of 2005). The difference is primarily due to lower proceeds under loans and borrowings in 2006 and larger loan repayments.

Operating Profit/Loss of the LOTOS Group by Business Segment

The operating activities of the LOTOS Group is divided into four business segments: crude oil production, refining and marketing, retail network, and other business.

- The crude oil production segment comprises activities related to acquisition of crude oil and natural gas reserves and crude oil and natural gas production.
- The refining, marketing and logistics segment comprises mainly the operations related to the production and processing of refined petroleum products, and their wholesale.
- The retail segment comprises the activities related to the sales conducted through the network of service stations controlled by the Group.
- The other business comprises auxiliary, transport, service and other activities.

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

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

(PLNm)	Business segments			
	Crude oil production	Refining and marketing	Retail	Other business
Sales revenue	82.0	2,661.7	202.1	62.7
Operating expenses	(29.3)	(2,583.4)	(210.1)	(54.2)
Adjustments	(2.0)	1.7	0.2	(0.9)
Operating profit	50.7	80.0	(7.8)	7.7
Amortisation and depreciation	10.6	52.4	6.4	2.0

Source: LOTOS Group.

Crude Oil Production

The Q1 2006 revenue on crude oil production was PLN 82.8m. Net of the operating expenses of PLN 29.3m and after adjustments, the operating profit amounted to PLN 50.7m, and earnings before interest, depreciation, income tax and amortization (EBITDA) reached PLN 61.3m.

The key driver of the Q1 2006 revenue in the production segment was the rise in light crude oil prices on international markets, as these provide the basis for calculation of the price of Rozewie crude produced by Petrobaltic and purchased by the LOTOS Group. The price quoted for the Brent oil was 61.74 USD/bbl, up by 9% on Q4 2005 and a 29% increase on Q1 2005. The Q1 2006 results of the crude oil production business were significantly affected by the increase in Petrobaltic's crude oil production from 39 thousand tonnes in the comparable period, i.e. February – March 2005 (period covered by consolidation) to 65.2 thousand tonnes in Q1 2006. Petrobaltic's actual production in Q1 2006 rose by 12.1% relative to the corresponding period of 2005.

Refining – Production and Marketing

In Q1 2006 the refining segment generated sales revenue of PLN 2,661.7m, operating profit of PLN 80.0m, and earnings before interest, depreciation, income tax and amortization (EBITDA) of PLN 132.4m. The segment's operating margin in Q1 2006 was 3.0%, while the EBITDA margin was 5.0%.

In Q1 2006 the Company posted an increase in revenue on oil processing and wholesale. The improvement followed the capacity expansion at the Gdańsk refinery, from 4.6m tonnes to 6m tonnes annually (30.4% increase), and the resulting growth of throughput from 1,075.8 thousand tonnes in Q1 2005 to 1,400.3 thousand tonnes in Q1 2006 (30.2% increase).

The refining segment's operating profit was determined to a large extent by market conditions. The Ural/Brent differential decreased merely by 1% relative to Q4 2005 and amounted to USD 3.64/bbl, but it fell by 28.6% in comparison with Q1 2005, when it stood at USD 5.09/bbl. At the same time, the refining margin grew by 41.4% relative to Q1 2005, reaching USD 4.12/bbl, but was 30.5% lower than the corresponding figure in Q4 2005. Crack margins for gasolines rose substantially in comparison with Q1 2005 (24.9%). The same is true of light fuel oil (7.7% rise) and aviation fuel (14.9% rise). Crack margins for diesel, on the other hand, fell by 10.6%.

Retail Operations (Service Stations Network)

In Q1 2006, sales revenue in the retail segment amounted to PLN 202.1m. The segment reported operating loss of PLN 7.8m and a negative EBIDTA of PLN 1.4.

Retail margins at CODO stations are of material bearing for the profit/loss on the operating level. In Q1 2006, they were 28% lower than in the corresponding period of 2005. In Q1 2006, the average annual turnover was 2.4m litres at the CODO stations and 1.4m litres at the DOFO stations.

It should be noted that the LOTOS service station network managed by LOTOS Paliwa S.A. is currently not profitable due to the ongoing restructuring and upgrading work. As at the end of Q1 2006, the number of CODO stations was 131, the number of DOFO stations reached 50 (with further 26 franchise agreements signed), and the number of DODO stations fell to 225.

The disappointing financial performance in the retail segment is also related to the cost of acquiring the operations of the ESSO and Slovnaft stations, as well as the cost of preparing the loyalty programmes which will be launched by the end of 2006.

Other Business

In Q1 2006, the sales revenue on other business reached PLN 62.7m, the segment's operating profit was PLN 7.7m, and EBITDA amounted to PLN 9.7m.

Impact of the LIFO Inventory Valuation on the Q1 2006 Consolidated Results of the LOTOS Group

In line with its inventory valuation policies, the LOTOS Group uses the weighted average of the acquisition cost to measure decrease in inventories. This method of stock valuation defers the effects of changes in oil prices on 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 drives such performance down. The net profit accounting for the impact of this valuation method is presented as item 1 in the table below. The consolidated net profit of the LOTOS Group for Q1 2006 accounting for the estimated impact of using the LIFO method for inventory valuation (along with the comparable data for Q1 2005) is presented as item 2:

No.	(PLNm)	Q1 2006	Q1 2005	Change
1.	**Net profit**	117.6	321.2	(63.5%)
2.	**Net profit (LIFO method)**	100.9	288.9	(65.1%)

Source: LOTOS Group.

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