MANAGEMENT DISCUSSION AND ANALYSIS OF THE Q2 2005 RESULTS

Introduction

With a view to implementing the *LOTOS Group Strategy until 2010,* adopted by the Supervisory Board in Q2 2005, the Management Board focused on the preparation and execution of the Initial Public Offering of Grupa LOTOS shares, necessary to raise the funds for implementation of the strategy. The success of the IPO and the placement of newly issued shares worth PLN 1.015bn with institutional and retail investors, will enable us to carry out the planned development projects aimed at increasing the Company's shareholder value, in particular of the Comprehensive Technical Upgrade Programme, the *PROSTA* Service Station Network Development Programme, and the programme of development of upstream operations.

The continuing favourable market conditions in the oil industry, coupled with the growth of the LOTOS Group, allowed the Company to improve its performance both compared with Q2 2004 and compared with Q1 2005, all in spite of the 47-day long overhaul shut-down, during which the Company performed the periodic repair and maintenance work on its installations. In Q2 2005 sales revenue was 17.3% higher than in the same period of the previous year. Operating profit increased by 37.7% to PLN 114.2m and net profit grew by 57.8% – to PLN 88.6m.

Preparation and Implementation of the Initial Public Offering of Grupa LOTOS Shares

The initial public offering of the Grupa LOTOS shares was the first stage of the Company's privatisation. The primary objective of the IPO was to increase the Group's share capital in order to provide it with funds necessary for the implementation of its development programmes. The Company offered 35m new issue shares (Series B Shares) and Nafta Polska was considering a sale of 8.9m of Series A Shares. The new issue shares were offered to Polish and foreign financial institutions and to Polish retail investors. After the May 2005 road show in Poland and abroad, the issue price range was set at PLN 26-35.5. As a result of the bookbuilding process, the shares issue price was set at PLN 29. Nafta Polska abandoned its plans to sell the shares, thus retaining its full stake. In total, investors subscribed for 343.8m Grupa LOTOS shares and subscription orders were subject to an average reduction of 89.8%. The Series A Shares and the allotment certificates to Series B Shares were first quoted at the stock exchange on June 9th 2005. Following the completion of the IPO, the Polish State Treasury and Nafta Polska hold 58.8% of Grupa LOTOS share capital. The amount of PLN 1.015bn raised by the Company in the public offering will allow it to implement its development programmes leading to value growth, and will enable all the shareholders to benefit from this growth.

Overhaul Shutdown and Capacity Expansion

Preparation for the periodic overhaul of key production units began 18 months prior to the date of the planned shutdown. The overhaul shutdown was coupled with thorough modernisation and extension of the existing key units, and its objective was to increase crude oil processing capacity from 4.5m tons to 6m tons annually. The units subject to modernisation were the atmospheric distillation unit, the vacuum distillation unit and the gasoline hydrotreatment unit. The work began on March 26th, 2005 and was completed on

May 11th, 2005, which means that the break in the processing of crude oil lasted 47 days, more than half of the second quarter of 2005.

The key guideline for the overhaul was timely execution of the planned work with a view to ensuring smooth and on-schedule start-up of all production units and their stable operation until the next overhaul, which is planned for 2008/2009.

In June 2005, the first full month of the refinery's operation after the overhaul and the capacity expansion, the capacity utilisation rate for key units ranged between 95% and 100%.

Due to the planned overhaul shutdown, the volume of crude oil processed in Q2 2005 was 778 thousand tons, while in Q1 2005 the Gdańsk refinery of the LOTOS Group processed over 1,076 tons of crude oil. The full effects of the overhaul and repair work executed during the shutdown will materialise in Q3 2005.

The cost of the overhaul work executed during the shutdown of the technological installations was in line with the Company's 2005 budget assumptions and amounted to PLN 46.8m.

Comprehensive Technical Upgrade Programme

As regards the execution of the Comprehensive Technical Upgrade Programme, which is a key factor in the Company's development and building of shareholder value, the Company's activities in Q2 2005 focused on further economic and market research, negotiations of agreements related to various areas of the project, and preparation of the financial model and the Information Memorandum concerning the Programme, to be provided to financial institutions.

In May 2005, Shell Global Solutions (SGS) delivered to the Company the final research report on the potential use of supplementary feedstock for the ROSE deasphalting unit and its effects on the design assumptions for key units covered by the Comprehensive Technical Upgrade Programme.

With a view to developing the initial procedure for selection and appointment of a general contractor for the project, workshops with Shell Global Solutions were held on June 21st–23rd, 2005.

In Q2 2005, significant progress was achieved in negotiations with SGS concerning the Project Management Support Agreement (PMSA), i.e. the support agreement for the Comprehensive Technical Upgrade Programme. A material advance was also made in negotiations with another business partner, concerning a long-term agreement for the supply of supplementary feedstock for the ROSE deasphalting unit.

In cooperation with BNP Paribas (the financial advisor), the work on the financial model for the Comprehensive Technical Upgrade Programme and the Initial Information Memorandum was being finalised with a view to delivering the Memorandum to financial institutions in August 2005. Negotiations of a new Cooperation Agreement with Lockheed Martin Corporation and M.W. Kellogg, concerning performance of Lockheed Martin's offset obligations relating to the Comprehensive Technical Upgrade Programme (the Agreement), were completed successfully. The Agreement concluded on June 23rd, 2005 replaced the relevant Agreement of September 18th, 2003. Signing of the Agreement and annexes to the licensing agreements, as well as payment by Lockheed Martin of the first licensing instalment, allowed for the licensing agreements to come into force in the second decade of June 2005 and the base design work on the installations comprising the Comprehensive Technical Upgrade Programme to begin.

In Q2 2005, annexes to three licence agreements were executed in relation to the deasphalting (June 6th, 2005), gasification (June 6th, 2005) and hydrocracking (June 28th, 2005) units.

PROSTA Service Station Network Development Programme

In Q2 2005, the Company's activities relating to the development of the retail fuel distribution network as part of the PROSTA Programme focused on the extension of the network of CODO stations and acquisition of new DOFO stations. The related work was executed by LOTOS Paliwa, a subsidiary.

As regards the development of CODO stations, LOTOS Paliwa acquired one service station, commenced the construction of four service stations (including two sites in the Upper Silesia region), upgraded 29 stations and implemented visual identification at three other facilities. In the area of the DOFO network development, seven new partnership agreements were signed, two new stations were incorporated into the network, and three DOFO stations received new visual identification. Additionally, as part of the consistent implementation of the PROSTA Programme's assumptions, the Company reduced the number of DODO stations by five.

As at June 30th, 2005, the network of LOTOS service stations comprised 349 sites, including 75 CODO stations, 245 DODO stations and 29 DOFO stations.

Capital expenditure under the PROSTA Programme, intended for the construction, acquisition and modernisation of service stations, development of trade partnership and other investments, was PLN 25.5m in Q2 2005. The amount invested, since the Programme was launched in 2004, totalled PLN 128m. The capital expenditure on the acquisition of service stations in Q2 2005 was 10% lower than assumed in the budget for the PROSTA Programme.

Petrobaltic and Oil Production

Q2 2005 was the first full reporting period of the LOTOS Group's operations after consolidation of Petrobaltic, an upstream company. In this period, Petrobaltic's production of crude oil within the Group exceeded 60 thousand tons, which, on account of lower throughput due to the overhaul shutdown, satisfied approx. 7% of the needs of the Gdańsk Refinery.

On June 17th, 2005, Grupa LOTOS entered into an agreement with PGNiG, PKN Orlen and Nafta Polska, concerning cooperation with respect to crude oil exploration and production. The parties to the agreement are interested in gaining access to oil reserves in the Middle East (including Kuwait, Iraq, Libya and Sudan) and in Kazakhstan. The consortium's activities will be co-ordinated by Nafta Polska.

Southern Refineries

Q2 2005 saw continuation of the restructuring initiatives aimed at streamlining the capital and organisational structure of the Group's operations in the South of Poland. The process included sale of two service stations by Rafineria Jasło SA to LOTOS Paliwa Sp. z o.o., and sale of a technical warehouse by Rafinera Czechowice SA to LOTOS Parafiny Sp. z o.o. In addition, work continued on preparing a concept for the operations of LOTOS Park Technologiczny Sp. z o.o. and on further business consolidation within the Group.

Moreover, Rafineria Jasło SA and Rafineria Czechowice SA are continuing investment projects aimed at their transformation into specialised business entities within the LOTOS Group – the Group's waste processing centre and logistic centre for southern Poland, respectively. Feasibility and profitability studies are being prepared for other investment projects in these areas.

The LOTOS Group's actions with regards to the Glimar Refinery (including a possible audit of the Hydrocomplex) depend, in the current situation, on the decision of the bankruptcy administrator. To date the administrator has only made an unsuccessful attempt to sell selected assets of the Glimar Refinery (service stations), postponing valuation of the Company's key assets, including the Hydrocomplex installation**.**

Market and Operational Review

In Q2 2005, the average price of Brent oil stood at USD 51.6/bbl, having gone up by 46.1% year on year. Compared with Q1 2005, in Q2 2005 the price grew by USD 3.9/bbl (8.3%). The significant rise over the last year went hand in hand with a higher Ural/Brent differential, which was the result of a mismatch between the demand and supply structure of light and heavy oils. The Ural/Brent differential went up from USD 3.1/bbl in Q2 2004 to USD 3.6/bbl in Q2 2005, but in comparison with Q1 2005 it dropped by 29.4%. At the same time, the continuous growth in demand for oil products and a very high level of capacity utilisation in Europe pushed the average refining margin up to USD 6.04/bbl in Q2 2005, compared with USD 5.8/bbl in the analogous period of 2004 and USD 3.6/bbl in Q1 2005. Crack margins for basic refinery products, such as gasoline, diesel oil or light fuel oil rose in Q2 2005 by 38.6%, 21.1% and 16.2%, respectively, in relation to Q1 2005, however compared with Q2 2004, only crack margins for diesel oil and fuel oil went up, by 63.8% and 46.6%, respectively, with a simultaneous 20.7% drop in crack margin for gasoline.

In Q2 2005, Grupa LOTOS (the refinery in Gdańsk) processed 778 thousand tons of crude oil, relative to 1.076m tons in Q1 2005. The drop was caused by a 47-day overhaul shutdown. The refinery in Gdańsk produced 195 thousand tons of motor gasoline, 283.2 thousand tons of diesel oil, 108.7 thousand tons of light fuel oil, 44.9 thousand tons of aviation fuel, and 102.8 thousand tons of heavy fuel oil.

Compared with Q1 2005, employment in the LOTOS Group in Q2 2005 grew only slightly (by 34 persons), totalling 5,256 employees (due to the assumption of control over Glimar Refinery by the bankruptcy administrator, we do not include this company's employees in the total employment figure of the LOTOS Group).

It is estimated that the domestic fuel consumption in the first five months of 2005 rose by 3.8% year on year, with the LOTOS Group's share in sales of gasoline, diesel oil, and light fuel oil at 22.1%, 21.6% and 24.0%, respectively. Over the period January–May 2005, the total share of the LOTOS Group in the domestic fuel market was 22.2%.

Extraordinary Events

In Q2 2005, Grupa LOTOS disposed of its shares in Przedsiębiorstwo Przeładunku Paliw Płynnych Naftoport to PERN Przyjaźń SA. Under the agreement signed on April 14th 2005, following the transaction clearance by the Polish Anti-Trust and Consumer Protection Authority, Grupa LOTOS sold 13 shares in the company, with the total par value of PLN 7,657, representing 16.67% of the share capital as at the agreement date. As a result, the share of Grupa LOTOS in PPPP Naftoport is now 8.97%.

The transaction was executed in connection with the State Treasury's activities and negotiations aimed at transferring control over Naftoport to PERN. As at the end of Q2 2005, PERN held 67.95% of Naftoport's share capital. Despite the disposal of the majority of its interest in the company, Grupa LOTOS has guaranteed itself access to Naftoport's reloading capacities to an extent which ensures full security in terms of feedstock and product transshipment.

Management Discussion and Analysis of the Consolidated Q2 and H1 2005 Results of the LOTOS Group

<u>Profit and Loss Account</u>

In the second quarter of 2005, the LOTOS Group generated sales revenue of PLN 2,146m, up by 17.3% on the Q2 2004 performance. Given the higher cost of sales, which rose by 24.8% year on year in the period, to amount to PLN 1,862m, the Group' profit on sales totalled PLN 284.1m, representing a 15.8% decrease in relation to Q2 2004. The drop was caused by the costs of the overhaul shutdown, which took place primarily in Q2 2004, and the related loss of refining margin, which in the shutdown period was significantly above the average for the entire quarter. Despite the fact that the LOTOS Group includes Petrobaltic, an upstream company, the margin realised on the sales of crude oil by Petrobaltic was excluded, as in Q1 2005, from consolidation, because the LOTOS Group did not sell any products made from the crude oil which was extracted at Rozewie after the acquisition of Petrobaltic by Grupa LOTOS.

In Q2 2005, the Group posted an operating profit of PLN 114.2m, a 37.7% year-on-year improvement (up by PLN 31.3m). The better operating profit follows from such factors as a material, more than 90%, reduction of other operating expenses, whose high level in 2004 resulted from write-offs and provisions made in connection with the financial situation of the Glimar Refinery.

The Q2 2005 pre-tax profit totalled PLN 111.8m, i.e. PLN 26.8m (31.5%) more than a year earlier. The year-on-year growth was attributable to the profit realised on the sale of shares in Naftoport Sp. z o.o. (associated company) and in PPU Ciech SA (other).

Following elimination of the profit attributable to minority interests, the Q2 2005 net profit totalled PLN 88.6m, representing a 57.8% improvement on the Q2 2004 figure.

In the first half of 2005, the sales revenue of the LOTOS Group totalled PLN 3,631.9m, up by 9.4% in relation to the analogous period of 2004. The figure includes revenue generated by the Southern Refineries and Petrobaltic (approx. PLN 245.9m) which were incorporated in the group of consolidated companies. If these companies were eliminated, the sales revenue increase would be less significant, at 2.0%. The consolidated H1 2005 operating profit stood at PLN 198.4m, down by PLN 3.9m (1.9%) from the first half of 2004. The drop resulted from a PLN 33.7m increase in general administrative expenses, following the inclusion of Petrobaltic, the Czechowice Refinery and the Jasło Refinery, increase in the Parent

Company's maintenance costs in connection with the overhaul shutdown in the first half of 2005, and the loss of margin caused by the 47-day production shutdown.

The H1 2005 consolidated pre-tax profit totalled PLN 196.1m, having grown by PLN 8.4m from the figure reported for H1 2004. The net profit was additionally reduced by the profit attributable to minority shareholders of Petrobaltic (PLN 11.1m), and amounted to PLN 141.3m, which means a 3.2% growth year on year.

Balance Sheet

As at June 30th, 2005, the Group's assets and equity and liabilities totalled PLN 6,123.5m, following an increase of PLN 2,101.0m during the first half of 2005. The main contributing factors were: a close to PLN 633m increase in property, plant and equipment, attributable partly to the consolidation of the Southern Refineries and Petrobaltic, and a more than PLN 205m increase in financial assets, following the acquisition of bonds financed with the proceeds from the issue of Grupa LOTOS shares, carried out in June.

The Group's current assets grew in H1 2005, primarily thanks to the higher production capacity of the Parent Company, higher prices of raw materials and products, and a higher balance of cash.

The Group saw its equity rise by more than PLN 1,135.9m, which resulted from a PLN 35m growth in the share capital and a nearly PLN 971m growth in reserve funds after the share capital increase.

Despite a reduction of the liabilities of Grupa LOTOS, the Group's loans and borrowing rose slightly. As at June 30th, 2005, the balance of current liabilities increased by PLN 792m from December 31st, 2004. This followed from an increase in current provisions, created in connection with the estimates adopted regarding the goodwill of companies which joined the Group as a result of the acquisition of shares in the Southern Refineries and Petrobaltic. In estimating the value of goodwill of the acquired companies, it was assumed in particular that the value of identifiable assets, liabilities and contingent liabilities was equal to the merger costs. The related provision amounted to PLN 274.9m. The balance of current liabilities was also affected by an increase in liabilities relating to the purchase of crude oil by the Parent Company.

Cash Flows

As at the end of the second quarter of 2005, the Group disclosed cash totalling PLN 567.4m, i.e. PLN 281.5m more than in the previous quarter. In the analogous period of 2004, the Group's cash had totalled PLN 109.3m (PLN 458.1m less).

In Q2 2005, net cash provided by operating activities was PLN 277.7m, representing a PLN 326.9m increase on Q2 2004. The primary reason for the higher net cash flows was the larger (by more than PLN 350m) balance of liabilities related to the purchase of crude oil and the higher (by PLN 16.2m) depreciation and amortisation, following, among others, the acquisition of Petrobaltic and the Southern Refineries.

Cash flows from investing activities in the second quarter of 2005 totalled PLN -765.4m, a change of PLN -785.3m as compared with the PLN 19.9m posted in Q2 2004. The increase was caused primarily by larger outflows: on the acquisition of current financial assets financed with the proceeds from the new issue of shares, on the acquisition of property, plant and equipment and intangible assets, and on the acquisition of non-current financial assets. The respective expenditures were up by PLN 678.5m, PLN 108.2m and PLN 111.2m, respectively.

In Q2 2004, the LOTOS Group had a large positive balance of cash flows from financing activities, totalling PLN 769.2m, which means an improvement of PLN 813.9m on Q2 2004 (when the net financing cash flow was PLN -44.7m). The high balance resulted from the issue of the Company shares, whose effect was offset by an outflow of cash on loan repayment.

As at the end of the two quarters of 2005, net cash provided by operating activities totalled PLN 295.6m, that is PLN 276.7m more than in the analogous period of 2004. The Group used PLN 746.8m in investing activities, PLN 716.5m more than a year earlier. In H1 2005, net cash provided by financing activities totalled PLN 861.1m, up by PLN 916.6m on Q2 2004.