



HRVATSKA ELEKTROPRIVREDA GROUP

Consolidated financial statements

As of 31 December 2010

together with Independent Auditor's Report

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Responsibility for the consolidated financial statements

Pursuant to the Croatian Accounting Law, the Management Board is responsible for ensuring that financial statements are prepared for each financial year in accordance with International Financial Reporting Standards ("IFRS") as published by the International Accounting Standards Board ("IASB") which give a true and fair view of the state of affairs and results of the Group for that period.

After making enquiries, the Management Board has a reasonable expectation that the Group has adequate resources to continue in operational existence for the foreseeable future. For this reason, the Management Board continues to adopt the going concern basis in preparing the financial statements.

In preparing those financial statements, the responsibilities of the Management Board include ensuring that:

- suitable accounting policies are selected and then applied consistently;
- judgments and estimates are reasonable and prudent;
- applicable accounting standards are followed, subject to any material departures disclosed and explained in the financial statements; and
- the financial statements are prepared on the going concern basis unless it is inappropriate to presume that the Group will continue in business.

The Management Board is responsible for keeping proper accounting records, which disclose with reasonable accuracy at any time the financial position of the Group and must also, ensure that the financial statements comply with the Croatian Accounting Law. The Management Board is also responsible for safeguarding the assets of the Group and hence for taking reasonable steps for the prevention and detection of fraud and other irregularities.

Signed on behalf of the Management Board:

Leo Begović
President of the Board

HEP d.d.
Ulica grada Vukovara 37
10000 Zagreb
Republic of Croatia
25 May 2011

Independent Auditor's Report

To the Owner of HEP d.d.:

We have audited the consolidated financial statements of the HEP Group (the 'Group'), which comprise the consolidated statement of financial position as at 31 December 2010 and the related consolidated income statement, consolidated statement of comprehensive income, consolidated statement of changes in equity and consolidated statement of cash flows for the year then ended, and a summary of significant accounting policies and other explanatory notes.

Management's Responsibility for the consolidated Financial Statements

Management is responsible for the preparation and fair presentation of these consolidated financial statements in accordance with International Financial Reporting Standards, and for such internal control as management determines is necessary to enable the preparation of consolidated financial statements that are free from material misstatement, whether due to fraud or error.

Auditor's Responsibility

Our responsibility is to express an opinion on these consolidated financial statements based on our audit. Except as provided in paragraphs a) and c) below, we conducted our audit in accordance with International Standards on Auditing. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the consolidated financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the consolidated financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the consolidated financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the Company's preparation and fair presentation of the consolidated financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Group's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the consolidated financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Independent Auditor's Report (continued)

Matters affecting the opinion

a) Prepayments to Hrvatske autoceste d.o.o.

As described in Note 13, the Group advanced HRK 300 million to Hrvatske autoceste d.o.o. in December 2006 for the acquisition of electricity facilities on the Croatian motorways within two years from the date of the advance payment. As of the date of these financial statements, the legal title to those facilities has not yet been transferred to the Group. The Group is the economic beneficiary of the electricity facilities, which it uses for their intended economic purposes and in the supply of electricity to customers. As of the date of publication of these financial statements, the Group has not classified the advance payment by type of assets used in the Group's business, and we have received no calculation of the economic impact of the reclassification of those assets from prepayments to assets in use and the related depreciation from the Management Board. As a result, we are unable to assess the impact of this matter on the Group's financial statements.

b) Impairment allowance on receivables

The auditor's opinion on the consolidated financial statements for the year ended 31 December 2009 was modified in respect of the provision for bad and doubtful receivables. During 2010, the Group recognised a provision for those receivables in the statement of comprehensive income. As at 31 December 2009, a provision for doubtful receivables of approximately HRK 60 million and the related taxation effect of approximately HRK 12 million were not recorded. As a result, the result for the year ended 31 December 2009 and shareholder's equity at 31 December 2009 were overstated by approximately HRK 48 million and the result for the year ended 31 December 2010 has been understated by the same amount.

c) Application of IFRIC 18 Transfers of Assets from Customers

The Group has not applied IFRIC 18 Transfers of Assets from Customers, which specifies the accounting for assets transferred from customers, by which the income from such assets should be recognised immediately upon the transfer in the statement of comprehensive income rather than deferred over the useful life of the transferred asset. The Interpretation is in force since 1 July 2009, and the Management Board has decided to apply the Interpretation to periods subsequent to 1 January 2010. As of the date of publication of these financial statements, the Group has not quantified the effect of untimely adoption of the Interpretation on the financial statements. As a result, we are unable to assess the impact of this matter on the statement of the comprehensive income of the Group for the year ended 31 December 2009 and on shareholder's equity for the year ended 31 December 2010. .

Independent Auditor's Report (continued)

Modified opinion

In our opinion, except for the effect of the matters discussed in paragraph b) above, and the potential effects of the matters discussed in paragraphs a) and c) above, the consolidated financial statements present fairly, in all material respects, the financial position of the Group at 31 December 2010, the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Deloitte d.o.o.

Branislav Vrtačnik, Certified Auditor

Zagreb, 25 May 2011

Consolidated Income Statement - HEP Group
For the year ended 31 December 2010

	Notes	2010 HRK'000	2009 HRK'000
Revenue from electricity sales	4	10,851,054	10,798,272
Revenue from thermal power sales	4	569,784	553,732
Revenue from gas sales	4	394,182	294,262
Other operating income	5	1,153,590	954,520
Total operating income		12,968,610	12,600,786
Electricity purchase cost		(2,011,535)	(3,078,977)
Fuel costs		(2,077,105)	(2,385,583)
Staff cost	6	(1,895,205)	(1,954,350)
Depreciation and amortization expense	10,11	(1,721,472)	(1,688,750)
Other operating expenses	7	(3,052,380)	(2,925,476)
Total operating expenses		(10,757,697)	(12,033,136)
Profit from operations		2,210,913	567,650
Financial revenue	8	65,479	81,101
Financial costs	8	(439,224)	(421,642)
Net financial loss		(373,745)	(340,541)
Profit before tax		1,837,168	227,109
Income tax expense	9	(401,802)	(72,687)
Profit from operations		1,435,366	154,422
Attributable to:			
Equity holder		1,421,303	135,844
Non-controlling interest		14,063	18,578
		1,435,366	154,422

The accompanying notes form an integral part of these consolidated financial statements.

Signed on behalf of the Company on 25 May 2011 by:

Leo Begović

President of the Board

Miljenko Pavlaković

Member of the Board

Consolidated Statement of comprehensive Income - HEP Group
For the year ended 31 December 2010

Notes	2010 HRK'000	2009 HRK'000
Profit for the year	<u>1,435,366</u>	<u>154,422</u>
Foreign exchange rate differences	17,840	(3,881)
Fair valuation of the Janaf shares	7,499	1,423
Other comprehensive income	-	(1,995)
Other comprehensive income / (loss)	<u>25,339</u>	<u>(4,453)</u>
Total comprehensive income for the year	<u>1,460,705</u>	<u>149,969</u>
Total comprehensive income attributable to:		
Equity holder	1,446,156	131,267
Non-controlling interest	14,549	18,702
	<u>1,460,705</u>	<u>149,969</u>

The accompanying notes form an integral part of these consolidated financial statements.

Signed on behalf of the Company on 25 May 2011 by:

Leo Begović
President of the Board

Miljenko Pavlaković
Member of the Board

Consolidated Statement of Financial Position – HEP Group
As at 31 December 2010

ASSETS	Notes	31 December 2010	31 December 2009
		HRK'000	HRK'000
Non-current assets			
Property, plant and equipment	10	24,090,370	24,082,799
Capital work in progress	10	3,046,316	3,130,294
Intangible assets	11	65,010	63,671
Investment property	12	223,094	202,467
Prepayments for property, plant and equipment	13	386,055	403,080
Investment in NPP Krško	14	1,622,947	1,605,593
Long-term loan receivables and deposits	16	1,183	1,483
Asset held for sale and other investments	17	162,380	152,997
Other non-current assets	18	110,973	117,106
Deferred tax assets	9	159,429	120,351
		<u>29,867,757</u>	<u>29,879,841</u>
Current assets			
Inventories	19	1,116,671	967,931
Trade receivables	20	1,730,328	1,493,989
Other short-term receivables	21	144,064	225,459
Cash and cash equivalents	22	762,157	143,834
		<u>3,753,220</u>	<u>2,831,213</u>
TOTAL ASSETS		<u>33,620,977</u>	<u>32,711,054</u>

The accompanying notes form an integral part of these consolidated financial statements.

Signed on behalf of the Company on 25 May 2011 by:

Leo Begović
President of the Board

Miljenko Pavlaković
Member of the Board

Consolidated Statement of Financial Position – HEP Group (continued)
As at 31 December 2010

CAPITAL AND LIABILITIES	Notes	31 December 2010	31 December 2009
		HRK'000	HRK'000
Share capital	23	19,792,159	19,792,159
Capital reserves	23	(1,005,546)	(2,038,472)
Retained earnings	23	816,246	403,018
Equity attributable to equity holder		19,602,859	18,156,705
Non-controlling interest	15	76,993	91,409
Total equity		19,679,852	18,248,114
Long-term borrowings	24	2,883,554	3,113,467
Long-term liabilities to the state	25	33,734	59,713
Long-term provisions	27	799,945	559,017
Liabilities under securities	28	1,058,042	1,150,887
Other long-term liabilities	29	5,170,943	4,927,022
Deferred tax liability		1,874	-
Total non-current liabilities		9,948,092	9,810,106
Trade payables		1,553,211	2,179,323
Current portion of long-term bonds issued	28	93,380	46,690
Current portion of long-term borrowings	24	1,184,921	947,747
Short-term borrowings	30	292,493	767,805
Taxes payable	31	444,985	171,080
Interest payable		30,489	64,301
Liabilities to employees	32	134,226	143,132
Other short-term payables	33	259,328	332,756
Total current liabilities		3,993,033	4,652,834
TOTAL CAPITAL AND LIABILITIES		33,620,977	32,711,054

The accompanying notes form an integral part of these consolidated financial statements.

Signed on behalf of the Company on 25 May 2011 by:

Leo Begović

President of the Board

Miljenko Pavlaković

Member of the Board

Consolidated Statement of Changes in Equity - HEP Group

For the year ended 31 December 2010

	Share capital	Capital reserves	Retained earnings/ (Accumulated losses)	Equity attributable to the equity holder of the Parent	Non.control ling interest	Total equity
	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000
Balance at 31 December 2008	19,792,159	(2,035,890)	267,155	18,023,424	106,821	18,130,245
Refit for HEP Telecom	-	-	19	19	-	19
Profit for the year	-	-	135,844	135,844	18,578	154,422
Exchange differences	-	(4,005)	-	(4,005)	124	(3,881)
Fair value of JANAF	-	1,423	-	1,423	-	1,423
Other comprehensive income	-	-	-	-	(1,995)	(1,995)
Total comprehensive income for the year	-	(2,582)	135,863	133,281	16,707	149,988
Non-controlling interest	-	-	-	-	(19,442)	(19,442)
Distribution of dividend to RWE	-	-	-	-	(12,677)	(12,677)
Balance at 31 December 2009	19,792,159	(2,038,472)	403,018	18,156,705	91,409	18,248,114
Allocation of retained earnings	-	1,008,073	(1,008,073)	-	-	-
Balance at 1 January 2010	19,792,159	(1,030,399)	(605,057)	18,156,703	91,409	18,248,112
Profit for the year	-	-	1,421,303	1,421,303	14,063	1,435,366
Exchange differences	-	17,354	-	17,354	486	17,840
Fair value of the JANAF shares	-	7,499	-	7,499	-	7,499
Total comprehensive income for the year	-	24,853	1,421,303	1,446,156	14,549	1,460,705
Non-controlling interest	-	-	-	-	(16,583)	(16,583)
Distribution of dividend to RWE	-	-	-	-	(12,382)	(12,382)
Balance at 31 December 2010	19,792,159	(1,005,546)	816,246	19,602,859	76,993	19,679,852

The accompanying notes form an integral part of these consolidated financial statements.

Signed on behalf of the Company on 25 May 2011 by:

Leo Begović

President of the Board

Miljenko Pavlaković

Member of the Board

Consolidated Statement of cash flows – HEP Group
For the year ended 31 December 2010

	2010	2009
	HRK'000	HRK'000
Cash flows from operating activities		
Profit for the year	1,435,366	154,422
Income tax expense recognised in profit	401,802	72,687
Net financial loss	373,745	340,541
(Gain) / loss from real estate fair valuation	(19,865)	19,748
Loss on derivatives	1,871	2,271
Depreciation and amortization	1,721,472	1,688,750
Increase in provisions for doubtful receivables	332,139	275,006
Increase in provision for inventories	15,070	110,647
Increase in provisions	240,928	137,017
<i>Operating cash flows before movements in working capital</i>	<u>4,502,528</u>	<u>2,801,089</u>
Increase in trade receivables	(568,478)	(349,881)
(Increase) / decrease in inventories	(163,810)	291,126
Decrease in other current assets	81,395	24,699
Decrease in trade payables	(626,112)	(430,450)
Increase in other liabilities	(121,984)	30,666
Increase in long-term liabilities	217,942	555,613
Cash generated from operations	<u>3,321,481</u>	<u>2,922,862</u>
Income taxes paid	(161,137)	(126,470)
Interest paid	(270,324)	(336,952)
NET CASH FROM OPERATING ACTIVITIES	<u>2,890,020</u>	<u>2,459,440</u>
INVESTING ACTIVITIES		
Interest received	14,480	7,529
Increase in property, plant and equipment	(1,693,299)	(2,359,657)
Write off property, plant and equipment	21,462	79,310
Increase of other assets	48,088	14,766
Change in the non-controlling interest and dividend payment to RWE	(28,479)	(33,971)
NET CASH USED IN INVESTING ACTIVITIES	<u>(1,637,748)</u>	<u>(2,292,023)</u>

Consolidated Statement of cash flows – HEP Group (continued)

For the year ended 31 December 2010

FINANCING ACTIVITIES

(Repayments) / proceeds from issuance of bonds	(46,155)	507
Received long-term loans	903,857	970,476
Repayment of long-term loans	(956,881)	(950,834)
Received short-term loans	566,692	710,092
Repayment of short-term loans	(1,101,462)	(1,064,341)
NET CASH (USED IN) / FROM FINANCING ACTIVITIES	(633,949)	(334,100)
NET (DECREASE) / INCREASE IN CASH AND CASH EQUIVALENTS	618,323	(166,683)
CASH AND CASH EQUIVALENTS AT BEGINNING OF YEAR	143,834	310,517
CASH AND CASH EQUIVALENTS AT THE END OF YEAR	762,157	143,834

The accompanying notes form an integral part of these consolidated financial statements.

Signed on behalf of the Company on 25 May 2011 by:

Leo Begović

President of the Board

Miljenko Pavlaković

Member of the Board

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

1. GENERAL

Hrvatska elektroprivreda Group (the 'Group') consists of the parent company Hrvatska elektroprivreda d.d., Zagreb ('HEP d.d.' or the 'Company') and the subsidiaries listed in Note 36.

HEP d.d. is registered in Zagreb, Ulica grada Vukovara 37. The principal activities of the HEP Group are the generation, transmission and distribution of electricity, and the control of the electric power systems. In addition to these main activities, the HEP Group deals with the generation and distribution of thermal power through the district heating systems in Zagreb and Osijek, and the distribution of gas in Osijek and Đakovo.

All the Group's activities are governed by applicable laws, regulations and decisions issued by the Croatian Government.

At 31 December 2010, the number of staff employed by the Group was 13,990 (31 December 2009: 14,197).

These financial statements are presented in Croatian Kuna (HRK) since that is the currency in which the majority of the Group's transactions are denominated.

Energy laws

On 3 December 2004, the Croatian Parliament ratified the amendments to the following laws: The Energy Law, the Law on Electricity Market and the Law on the Regulation of Energy Activities.

HEP d.d. and its subsidiaries continue to provide their services as regulated public services as follows: electricity generation for tariff-based customers, electricity transmission, electricity distribution and electricity supply for tariff-based customers.

Generation and supply of electricity for eligible customers, (eligibility as described by the group of tariff laws) and trading on the energy market are performed as market activities.

The supply of electricity to eligible customers is performed according to rules governing market relations, which allow negotiating electricity quantities and prices on a free-market basis. Electricity for households and those preferential customers that have not exercised their right to select the electricity supplier or are left without a supplier is supplied as part of the system of obligatory public services.

In June 2008, the Government of the Republic of Croatia promulgated a Decision on The Electricity Generation Tariff Model, with the exemption of eligible customers, with no tariff item amounts; The Electricity Transmission Tariff Model, with no tariff item amounts; The Electricity Distribution Tariff Model, with no tariff amounts; and the Electricity Supply Tariff Model, with the exemption of eligible customers, with no tariff amounts. The Group has been applying the tariff models since 1 July 2008.

1. GENERAL (continued)

Energy Laws (continued)

In December 2008, the Law on the Amendments to the Electricity Market Law became effective, under which small customers were obliged to choose their supplier and sign a contract with that chosen supplier by 30 June 2009, which is the date until which they are entitled to receive energy supplied by suppliers of tariff customers.

Small customers failing to select their electricity supplier until the given date will be charged for the supply of electricity based on the balancing electricity price charged to customers who have not selected their supplier either.

According to the new laws, HEP d.d. restructured its operations, by forming separate companies for electricity generation, transmission of electricity, distribution of electricity, electricity supply and electricity trading. HEP d.d. has restructured the Group in accordance with the amended laws.

Law on the Privatisation of HEP d.d.

The Law on the Privatisation of Hrvatska Elektroprivreda d.d. was passed on 25 March 2002. On 5 February 2010 this law was annulled as the Government passed the Law on Invalidity of the Law on the Privatization of Hrvatska elektroprivreda d.d.

1. GENERAL (continued)

Governance and management

General assembly

The General assembly consists of the members representing the interests of the HEP d.d.:

Đuro Popijač	President	Member since 21 November 2009
Miljenko Pavlaković	President	Member from 14 February 2008 until 30 October 2009

Supervisory Board of HEP d.d.

Members of Supervisory Board in 2010 and 2009:

Darko Horvat	President	Member since 30 June 2010, President since 20 July 2010
Branimir Horaček	President	Member from 19 October 2009 until 6 May 2010
Dražen Bošnjaković	Member	Member since 19 October 2009
Krešimir Dragić	Member	Member since 19 October 2009
Slavko Konfic	Member	Member since 28 April 2008
Gordana Obran	Member	Member since 19 October 2009
Zvonimir Sabati	Member	Member since 19 October 2009
Jadranko Berlengi	Member	Member since 3 June 2008

Leo Begović	President	Member from 28 April 2008 until 22 September 2009
Krešimir Ćosić	Member	Member from 28 April 2008 until 19 October 2009
Dasenko Baldasari	Member	Member from 28 April 2008 until 19 October 2009
Luciano Delbianco	Member	Member from 28 April 2008 until 19 October 2009
Zdenko Jurčić	Member	Member from 28 April 2008 until 19 October 2009
Slavko Konfic	Member	Member from 28 April 2008
Jadranko Berlengi	Member	Member from 03 June 2008

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

1. GENERAL (continued)

Management Board in 2010 and 2009:

Leo Begović	President	Member since 25 September 2009
Dubravko Lukačević	Member	Member since 2 November 2009
Snježana Pauk	Member	Member since 2 November 2009
Miljenko Pavlaković	Member	Member since 2 November 2009
Damir Pečvarac	Member	Member since 2 November 2009
Velimir Rajković	Member	Member since 2 November 2009

Ivan Mravak	President	Member from 2004 till 25 September 2009
Željko Kljaković-Gašpić	Member	Member from 1 March 2008 until 25 September 2009
Darko Dvornik	Member	Member from 1 March 2008 until 25 September 2009
Stjepan Tvrdinić	Member	Member from 18 March 2008 until 25 September 2009
Željko Tomšić	Member	Member from 29 April 2008 until 25 September 2009
Nikola Rukavina	Member	Member from 29 April 2008 until 25 September 2009

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

A summary of the Group's principal accounting policies which have been applied consistently in the current year and with the prior year, is set out below.

Presentation of the financial statements

The financial statements have been prepared in accordance with International Financial Reporting Standards ("IFRS") as published by the International Accounting Standards Board.

The financial statements have been prepared on the historical cost basis, except for certain financial instruments that are presented at re valued amounts. The financial statements are presented in thousands of Croatian Kuna (HRK'000), since that is the currency in which the majority of the Group's transactions are denominated.

The financial statements have been prepared under the going-concern assumption.

Basis of accounting

The Group maintains its accounting records in the Croatian language, in Croatian kuna and in accordance with Croatian law and the accounting principles and practices observed by enterprises in Croatia. The accounting records of the Group's subsidiaries in Croatia and abroad are maintained in accordance with the requirements of the respective local jurisdictions.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Adoption of new and revised standards

Standards and Interpretations effective in the current period

The following amendments to the existing standards issued by the International Accounting Standards Board and interpretations issued by the International Financial Reporting Interpretations Committee are effective for the current period:

- **IFRS 1 (revised) “First-time Adoption of IFRS”** (effective for annual periods beginning on or after 1 July 2009),
- **IFRS 3 (revised) “Business Combinations”** (effective for annual periods beginning on or after 1 July 2009),
- **Amendments to IFRS 1 “First-time Adoption of IFRS”- Additional Exemptions for First-time Adopters** (effective for annual periods beginning on or after 1 January 2010),
- **Amendments to IFRS 2 “Share-based Payment”** - Group cash-settled share-based payment transactions (effective for annual periods beginning on or after 1 January 2010),
- **Amendments to IAS 27 “Consolidated and Separate Financial Statements”** (effective for annual periods beginning on or after 1 July 2009),
- **Amendments to IAS 39 “Financial Instruments: Recognition and Measurement”** - Eligible hedged items (effective for annual periods beginning on or after 1 July 2009),
- **Amendments to various standards and interpretations “Improvements to IFRSs (2009)”** resulting from the annual improvement project of IFRS published on 16 April 2009 (IFRS 2, IFRS 5, IFRS 8, IAS 1, IAS 7, IAS 17, IAS 18, IAS 36, IAS 38, IAS 39, IFRIC 9 and IFRIC 16) primarily with a view to removing inconsistencies and clarifying wording, (most amendments are to be applied for annual periods beginning on or after 1 January 2010),
- **IFRIC 17 “Distributions of Non-Cash Assets to Owners”** (effective for annual periods beginning on or after 1 July 2009),
- **IFRIC 18 “Transfers of Assets from Customers”** (effective for transfer of assets from customers received on or after 1 July 2009)

The adoption of these amendments to the existing standards and interpretations has not led to any changes in the Group’s accounting policies.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Adoption of new and revised standards (continued)

Standards and Interpretations in issue not yet adopted

At the date of authorisation of these financial statements the following standards, revisions and interpretations were in issue but not yet effective:

- **IFRS 9 “Financial Instruments”** (effective for annual periods beginning on or after 1 January 2013),
- **Amendments to IFRS 1 “First-time Adoption of IFRS”- Limited Exemption from Comparative IFRS 7 Disclosures for First-time Adopters** (effective for annual periods beginning on or after 1 July 2010),
- **Amendments to IFRS 1 “First-time Adoption of IFRS”- Severe Hyperinflation and Removal of Fixed Dates for First-time Adopters** (effective for annual periods beginning on or after 1 July 2011),
- **Amendments to IFRS 7 “Financial Instruments: Disclosures”- Transfers of Financial Assets** (effective for annual periods beginning on or after 1 July 2011),
- **Amendments to IAS 12 “Income Taxes” - Deferred Tax: Recovery of Underlying Assets** (effective for annual periods beginning on or after 1 January 2012),
- **Amendments to IAS 24 “Related Party Disclosures” - Simplifying the disclosure requirements for government-related entities and clarifying the definition of a related party** (effective for annual periods beginning on or after 1 January 2011),
- **Amendments to IAS 32 “Financial Instruments: Presentation” – Accounting for rights issues** (effective for annual periods beginning on or after 1 February 2010),
- **Amendments to various standards and interpretations “Improvements to IFRSs (2010)”** resulting from the annual improvement project of IFRS published on 6 May 2010 (IFRS 1, IFRS 3, IFRS 7, IAS 1, IAS 27, IAS 34, IFRIC 13) primarily with a view to removing inconsistencies and clarifying wording (most amendments are to be applied for annual periods beginning on or after 1 January 2011),
- **Amendments to IFRIC 14 “IAS 19 — The Limit on a defined benefit Asset, Minimum Funding Requirements and their Interaction” - Prepayments of a Minimum Funding Requirement** (effective for annual periods beginning on or after 1 January 2011),
- **IFRIC 19 “Extinguishing Financial Liabilities with Equity Instruments”** (effective for annual periods beginning on or after 1 July 2010).

The Group has elected not to adopt these standards, revisions and interpretations in advance of their effective dates. The Group anticipates that the adoption of these standards, revisions and interpretations will have no material impact on the financial statements of the Group in the period of initial application except for IFRS 9 *Financial Instruments* which will have an impact on the measurement and disclosure of financial instruments.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

The basis of the preparation of the Group's financial statement

The financial statements of the Group represent aggregate amounts of the assets, liabilities, capital and reserves, and the results of its operations for the year then ended. All intragroup balances and transactions have been eliminated.

Principles and methods of consolidation

The consolidated financial statements incorporate the financial statements of HEP d.d. and entities controlled by HEP d.d. (its subsidiaries). A listing of the Group's subsidiaries is provided in Note 36. Control is achieved where HEP d.d. has the power to govern the financial and operating policies of an entity so as to obtain benefits from its activities.

The results of subsidiaries acquired or disposed of during the year are included in the consolidated income statement from the effective date of acquisition or up to the effective date of disposal, as appropriate.

Where necessary, adjustments are made to the financial statements of subsidiaries to bring their accounting policies into line with those used by other members of the Group.

All intragroup transactions, balances, income and expenses are eliminated on consolidation.

Non-controlling interests in the net assets of consolidated subsidiaries are identified separately from the Group's equity therein. Non-controlling interests consist of the amount of those interests at the date of the original business combination and the non-controlling's share of changes in equity since the date of the combination. Losses applicable to the non-controlling in excess of the non-controlling interest in the subsidiary's equity are allocated against the interests of the Group except to the extent that the holders of the non-controlling interests have a binding obligation and are able to make an additional investment to cover the losses.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Investments in associates

An associate is an entity over which the Group is in a position to exercise significant influence, but not control or joint control, through participation in the financial and operating policy decisions of the investee.

The results and assets and liabilities of associates are incorporated in these consolidated financial statements using the equity method of accounting except when classified as held for sale in accordance with IFRS 5 *Non-current Assets Held For Sale and Discontinued Operations*.

Investments in associates are carried in the consolidated statement of financial position at cost as adjusted by post-acquisition changes in the Group's share of the net assets of the associate, less any impairment in the value of individual investments. Losses of an associate in excess of the Group's interest in that associate (which includes any long-term interests that, in substance, form part of the Group's net investment in the associate) are not recognised, unless the Group has incurred legal or constructive obligations or made payments on behalf of the associate.

Any excess of the cost of acquisition over the Group's share of the fair values of the identifiable net assets of the associate at the date of acquisition is recognised as goodwill. Goodwill is included in net book value of investments and is tested for impairment as part of investment. Any deficiency of the cost of acquisition below the Group's share of the fair values of the identifiable net assets of the associate at the date of acquisition is credited to profit and loss in the period of acquisition.

Where the Group transacts with its associate, profits and losses are eliminated to the extent of the Group's interest in the relevant associate.

Investments in jointly controlled entities

Jointly controlled entities are entities where Group and other parties are engaged in business activities under the joint control; i.e. when strategic financial and business decisions demands unanimous approval of all parties that participate in control.

Where a Group entity undertakes its activities under joint venture arrangements directly, the Group's share of jointly controlled assets and any liabilities incurred jointly with other ventures are recognised in the financial statements of the relevant entity and classified according to their nature. Liabilities and expenses incurred directly in respect of interests in jointly controlled assets are accounted for on an accrual basis. Income from the sale or use of the Company's share of the output of jointly controlled assets, and its share of joint venture expenses, are recognised when it is probable that the economic benefits associated with the transactions will flow to / from the Company and their amount can be measured reliably.

Joint venture arrangements that involve the establishment of a separate entity in which each venture has an interest are referred to as jointly controlled entities. The Group reports its interests in jointly controlled entities using full consolidation.

2.SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Retirement and other employee benefit costs

The Group has no defined post-retirement benefit plans for its employees or management in Croatia or abroad. Accordingly, no provision for these costs has been included.

Legal pension and health insurance contributions are paid on behalf of the Group's employees in the Republic of Croatia. This obligation applies to all staff hired on the basis of employment contract. The contributions are paid at a certain percentage determined on the basis of gross salary.

	2010
Pension insurance contributions	20%
Health insurance contributions	15%
Employment Fund contribution	1.7%
Occupational injury	0.5%

The Group companies have the obligation to withhold the pension insurance contributions from the employees' gross salaries.

Contributions on behalf of the employer and the employees are recognised as cost in the period in which they are incurred (see Note 6).

Retirement benefits and jubilee awards

The Group provides benefits to its employees, which include long-service benefits (jubilee awards) and one-off retirement benefits. The obligation and the cost of these benefits are determined using the Projected Unit Credit Method. The Projected Unit Credit Method considers each period of service as giving rise to an additional unit of benefit entitlement and measures each unit separately to build up the final obligation. The obligation is measured at the present value of estimated future cash flows using a discount rate that is similar to the interest rate on government bonds where the currency and terms of the Government bonds are consistent with the currency and estimated terms of the benefit obligation. Calculations of the obligation and cost of these benefits are performed by a certified actuary.

Jubilee bonuses

The Group provides benefits to its employees for long term work (jubilee bonuses) and severance payments when retirement. Benefit for long term work amounts from HRK to 1,650 HRK 5,500 net for work in Group from 10 to 40 years continuously.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Retirement benefits and jubilee awards (continued)

Severance payments

A Collective Agreement has been in effect since 1 July 2008, under which the employees are entitled to a retirement benefit to the extent of 1/8 of the average gross monthly salary earned in the period of three months prior to the retirement for each completed year of continuous employment at the employer. The effective date of the Collective Agreement was extended until 31 December 2010. A new Collective Agreement was adopted as of 12 January 2011, effective from January 1, 2011, and is valid until 31 December 2012.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)***Property, plant and equipment***

Property, plant and equipment are carried at cost less accumulated depreciation and any impairment losses, except for land, which is carried at cost.

The estimated useful lives, residual values and depreciation methods are reviewed at each year end, with the effect of any changes in estimate recognised within income statement.

Property, plant and equipment in use are depreciated using the straight-line method on the following bases:

Buildings	2010 and 2009
Hydroelectric power plants (Dams, embankments, buildings and other structures and facilities)	20 – 50 years
Thermal power plants (Buildings and other structures)	33 – 50 years
Electricity transmission and distribution plants and facilities (Transmission lines and buildings of transformer stations, switch-yard, dispatch centers and others)	20 – 40 years
Water and steam pipelines and other thermal power generation and transmission plants and facilities	33 years
Gas pipelines	20 - 25 years
Administrative buildings	50 years
Plant and equipment	
Hydroelectric power plants	10 – 33 years
Thermal power plants	6 – 25 years
Electricity transmission plants and facilities (electric parts of transformer stations and transformer; and electric parts of transmission lines)	15 – 40 years
Electricity distribution plants and facilities (electric parts of transformer stations and transformers, electric parts of distribution lines, measuring instruments, meters and other equipment)	8 – 40 years
Thermal power stations, hot-water pipelines and other equipments	15 – 30 years
Gas meters and other gas network equipment	5 – 20 years
Other equipment and vehicles	
IT equipment	5-20 years
Software licenses	5 years
Telecommunications equipment	5 – 20 years
Motor vehicles	5 – 8 years
Office furniture	10 years

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Property, plant and equipment (continued)

The initial cost of property, plant and equipment contain the purchase price, including all customs duties and non-refundable taxes and all costs directly attributable to bringing an asset to the condition and location for its intended use. Expenditures incurred after the property, plant and equipment have been put into use are charged to expense the period in which they are incurred.

In situations where it can be clearly demonstrated that the expenditures have resulted in an increase in the future economic benefits expected to be obtained from the use of an item of property, plant and equipment beyond its originally assessed standard performance, the expenditures are capitalised as an additional cost of property, plant and equipment. Costs eligible for capitalization include costs of periodic, planned significant inspections and overhauls necessary for further operation.

The gain or loss arising from disposal or withdrawal of property, plant and equipment is determined as the difference between the gains on sale and the carrying amount of the asset and are credited and charged, respectively, to the income statement.

Impairment of tangible and intangible assets

Items of tangible and intangible assets are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount of an asset may not be recoverable. Whenever the carrying amount of an asset exceeds its recoverable amount, an impairment loss is charged to the income statement.

At each reporting date, the Group reviews the carrying amounts of its tangible and intangible assets to determine whether there is any indication that those assets have suffered an impairment loss. If any such indication exists, the recoverable amount of the asset is estimated in order to determine the extent of the impairment loss (if any). Where it is not possible to estimate the recoverable amount of an individual asset, the Group estimates the recoverable amount of the cash-generating unit to which the asset belongs.

Intangible assets with indefinite useful lives and intangible assets not yet available for use are tested for impairment annually, and whenever there is an indication that the asset may be impaired.

Recoverable amount is the higher of fair value less costs to sell and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Property, plant and equipment (continued)

The net selling price is the amount obtainable from the sale of an asset in an arm's length transaction less the cost of disposal, while value in use is the present value using a pre-tax discount rate that reflects current market assessments of the time value of money and the risks specific to the asset of estimated future cash flows expected to arise from the continuing use of an asset and from its disposal at the end of its useful life. Recoverable amounts are estimated for individual assets or, if it is not possible, for the relevant cash-generating unit.

If the recoverable amount of an asset (or cash-generating unit) is estimated to be less than its carrying amount, the carrying amount of the asset (or cash-generating unit) is reduced to its recoverable amount. An impairment loss is recognised immediately in profit or loss, unless the relevant asset is land or a building other than an investment property carried at a revalued amount, in which case the impairment loss is treated as a revaluation decrease.

Where an impairment loss subsequently reverses, the carrying amount of the asset (cash-generating unit) is increased to the revised estimate of its recoverable amount, but so that the increased carrying amount does not exceed the carrying amount that would have been determined had no impairment loss been recognised for the asset (cash-generating unit) in prior years. A reversal of an impairment loss is recognised immediately in profit or loss, unless the relevant asset is carried at a revalued amount, in which case the reversal of the impairment loss is treated as a revaluation increase.

Intangible assets

Intangible fixed assets include patents, trademarks and licenses and are carried at cost less accumulated amortisation. Amortisation is provided on a straight-line basis over a period from 5 to 20 years.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Investment property

Investment properties are properties held to earn rentals and/or for capital appreciation (including property under construction for such purposes). Investment properties are measured initially at cost, including transaction costs. Subsequent to initial recognition, investment properties are measured at fair value. Gains and losses arising from changes in the fair value of investment properties are included in profit or loss in the period in which they arise.

An investment property is derecognised upon disposal or when the investment property is permanently withdrawn from use as well as when no future economic benefits are expected from the disposal. Any gain or loss arising on derecognition of the property (calculated as the difference between the net disposal proceeds and the carrying amount of the asset) is included in profit or loss in the period in which the property is derecognised.

Finance and operating leases

The Group as lessee

The Group has no significant finance lease arrangements and no significant operating lease arrangements were entered during 2010 and 2009. Amounts payable under operating leases are recognised as expense on a straight-line basis over the term of the relevant lease, unless there is another systematic basis that would be more representative of the time pattern of the user's benefit.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)***Trade debtors and prepayments***

Trade receivables are carried at cost less provision for bad and doubtful receivables.

Management provides for doubtful receivables based on a review of the overall ageing of all receivables and a specific review of significant individual amounts receivable.

As the collectability of certain receivables over a longer term is not certain, the Group makes an allowance for unrecoverable amounts, based on a reasonable estimate and past experience, in order to value adjust those amounts as follows during 2009 year:

Ageing of past due	Allowance percentage
61 – 90 days	5%
91 - 120 days	10%
121 - 365 days	20%
Over one year	100%

In 2010 Group has changed percentages of allowance based on review of actual experience :

Ageing of past due	Allowance percentage
31 – 60 days	1.5%
61 – 90 days	3%
91 - 180 days	9%
181 - 365 days	30%
Over one year	90%

Outstanding receivables claimed through court and those included in bankruptcy estate (the debt principal and interest) are fully provided for, regardless of the number of past due days, and the provision is charged to expenses.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Inventories

Inventories comprise mainly of materials and small items and are carried at the lower of cost, determined using the weighted average price less allowance for obsolete and excessive inventories, and net realisable value. The management provides for inventories based on a review of the overall ageing structure of inventories and non-recurring transfers over the years, as well as of individual significant amounts of inventories.

Cost comprises the invoiced amount as well as all other costs directly attributable to bringing inventories to their location and the condition of being readily available for use.

Cash and cash equivalents

Cash and cash equivalents comprise cash on hand and demand deposits with banks and other short-term highly liquid investments that are readily convertible to a known amount of cash and are subject to an insignificant risk of changes in value.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Borrowing costs

Borrowing costs directly attributable to the acquisition, construction or production of qualifying assets, which are assets that necessarily take a substantial period of time to get ready for their intended use or sale, are added to the cost of those assets, until such time as the assets are substantially ready for their intended use or sale. Investment income earned on the temporary investment of specific borrowings pending their expenditure on qualifying assets is deducted from the borrowing costs eligible for capitalisation.

All other borrowing costs are recognised in the statement of income in the period in which they are incurred. Short-term borrowings and supplier loans are recorded at original amount granted less repayment. Interest expense is charged to income statement on an accrual basis.

Foreign currencies

The individual financial statements of each Group entity are presented in the currency of the primary economic environment in which the entity operates (its functional currency). For the purpose of the consolidated financial statements, the results and financial position of each Group entity are expressed in Croatian kunas (HRK), which are the functional currency of the Company and the presentation currency for the consolidated financial statements.

In preparing the financial statements of the individual Group entities, transactions in currencies other than the entity's functional currency (foreign currencies) are translated to the functional currency of the entity at the rates of exchange prevailing on the dates of the transactions. At each reporting date, monetary items denominated in foreign currencies are retranslated to the functional currency of the entity at the year-end rates. Non-monetary items carried at fair value that are denominated in foreign currencies are retranslated at the rates prevailing on the date when the fair value was determined. Non-monetary items that are measured in terms of historical cost in a foreign currency are not retranslated.

Exchange differences arising on the settlement of monetary items, and on the retranslation of monetary items, are included in profit or loss for the period. Exchange differences arising on the retranslation of non-monetary items carried at fair value are included in profit or loss for the period as finance cost except for differences arising on the retranslation of non-monetary assets available for sale, in respect of which gains and losses are recognised directly in equity. For such non-monetary items, any exchange component of that gain or loss is also recognised directly in equity.

For the purpose of presenting consolidated financial statements, the assets and liabilities of the Group's foreign operations are expressed in Croatian kuna using exchange rates prevailing at the date of the statement of financial position. Income and expense items are translated at the average exchange rates for the period, unless exchange rates fluctuated significantly during that period, in which case the exchange rates at the dates of the transactions are used. Exchange differences arising on the year-end translation, if any, are classified as equity and recognised in the Group's foreign currency translation reserve. Such exchange differences are recognised in profit or loss in the period in which the foreign operation is disposed of.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Taxation

The tax expense represents the sum of the tax currently payable and deferred tax.

Current tax

The tax currently payable is based on taxable profit for the year. Taxable profit differs from profit as reported in the income statement because it excludes items of income or expense that are taxable or deductible in other years and it further excludes items that are never taxable or deductible. The Group's liability for current tax is calculated using tax rates that have been enacted or substantively enacted by the end of reporting period.

Deferred tax

Deferred tax is recognised on differences between the carrying amounts of assets and liabilities in the financial statements and the corresponding tax bases used in the computation of taxable profit, and are accounted for using the balance sheet liability method. Deferred tax liabilities are generally recognised for all taxable temporary differences, and deferred tax assets are generally recognised for all deductible temporary differences to the extent that it is probable that taxable profits will be available against which those deductible temporary differences can be utilised. Such assets and liabilities are not recognised if the temporary difference arises from goodwill or from the initial recognition (other than in a business combination) of other assets and liabilities in a transaction that affects neither the taxable profit nor the accounting profit.

Deferred tax liabilities are recognised on the basis of taxable temporary differences on investments in subsidiaries and associates and joint ventures, unless the Group is able to control the reversal of the temporary difference and it is probable that the temporary difference will not reverse in foreseeable future.

The carrying amount of deferred tax assets is reviewed at the end of each reporting period and reduced to the extent that it is no longer probable that sufficient taxable profits will be available to allow all or part of the asset to be recovered.

Deferred tax assets and liabilities are measured at the tax rates that are expected to apply in the period in which the liability is settled or the asset realised, based on tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period. The measurement of deferred tax liabilities and assets reflects the amount in which the Group expects, at the reporting date, to recover or settle the carrying amount of its assets and liabilities.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Taxation (continued)

Current and deferred tax for the period

Current and deferred tax are recognised as an expense or income in profit or loss, except when they relate to items credited or debited directly to equity, in which case the tax is also recognised directly in equity, or where they arise from the initial accounting for a business combination.

In the case of a business combination, the tax effect is taken into account in calculating goodwill or in determining the excess of the acquirer's interest in the net fair value of the acquiree's identifiable assets, liabilities and contingent liabilities over cost.

Financial assets

Investments are recognised and derecognised on a trade date where the purchase or sale of an investment is under a contract whose terms require delivery of the investment within the timeframe established by the market concerned, and are initially measured at fair value, net of transaction costs, except for those financial assets classified as at fair value through profit or loss, which are initially measured at fair value.

Financial assets are classified into as "assets available for sale" and "loans and receivables". The classification depends on the nature and purpose of the financial assets and is determined at the time of initial recognition.

Effective interest method

The effective interest method is a method of calculating the amortised cost of a financial asset and of allocating interest income over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash receipts through the expected life of the financial asset, or, where appropriate, a shorter period.

Income is recognised on an effective interest basis for debt instruments.

Financial assets available for sale

Unlisted shares held by the Group that are traded in an active market are classified as being AFS and are stated at fair value. Gains and losses arising from changes in fair value are recognised directly in equity in the investments revaluation reserve with the exception of impairment losses, interest calculated using the effective interest method and foreign exchange gains and losses on monetary assets, which are recognised directly in profit or loss. Where the investment is disposed of or is determined to be impaired, the cumulative gain or loss previously recognised in the investments revaluation reserve is included in profit or loss for the period.

Dividends on AFS equity instruments are recognised in profit or loss when the Group's right to receive the dividends has been established.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Financial assets (continued)

The fair value of AFS financial assets denominated in a foreign currency is determined in that foreign currency and translated at the spot rate at the end of reporting period. The change in fair value attributable to translation differences that result from a change in amortised cost of the asset is recognised in profit or loss, and other changes are recognised in equity.

Loans and receivables

Trade receivables, loans, and other receivables with fixed or regular payments that are not quoted in an active market are classified as loans and receivables. Loans and receivables are measured at amortised cost using the effective interest method, less any impairment. Interest income is recognised by applying the effective interest rate, except for short-term receivables when the recognition of interest would be immaterial.

Impairment of financial assets

Financial assets are assessed for indicators of impairment at the end of each reporting period. Financial assets are impaired where there is objective evidence that, as a result of one or more events that occurred after the initial recognition of the financial asset, the estimated future cash flows of the investment have been impacted. For financial assets carried at amortised cost, the amount of the impairment is the difference between the asset's carrying amount and the present value of estimated future cash flows, discounted at the financial asset's original effective interest rate.

The carrying amount of the financial asset is reduced by the impairment loss directly for all financial assets with the exception of trade receivables, where the carrying amount is reduced through the use of an allowance account. When a trade receivable is considered uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off are credited against the allowance account. Changes in the carrying amount of the allowance account are recognised in profit or loss.

With the exception of AFS equity instruments, if, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognised, the previously recognised impairment loss is reversed through profit or loss to the extent that the carrying amount of the investment at the date the impairment is reversed does not exceed what the amortised cost would have been had the impairment not been recognised.

In respect of AFS equity securities, any increase in fair value subsequent to an impairment loss is recognised directly in equity.

Investments

Investments in immaterial non-consolidated companies are generally recorded at cost less provisions for any impairment.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Financial liabilities

Other financial liabilities (including borrowings) are subsequently measured at amortised cost using the effective interest method.

The effective interest method is a method of calculating the amortised cost of a financial liability and of allocating interest expense over the relevant period. The effective interest rate is the rate that exactly discounts estimated future cash payments (including all fees and points paid or received that form an integral part of the effective interest rate, transaction costs and other premiums or discounts) through the expected life of the financial liability, or (where appropriate) a shorter period, to the net carrying amount on initial recognition.

Derecognition of financial liabilities

The Group derecognises financial liabilities when, and only when, the Group's obligations are discharged, cancelled or they expire. The difference between the carrying amount of the financial liability derecognised and the consideration paid and payable is recognised in profit or loss.

Derivative financial instruments

The Group entered into an interest rate swap to manage its exposure to interest rate. Further details of derivative financial instruments are disclosed in Note 26.

Derivatives are initially recognised at fair value at the date the derivative contracts are entered into and are subsequently remeasured to their fair value at the end of each reporting period. The resulting gain or loss is recognised in profit or loss immediately unless the derivative is designated and effective as a hedging instrument, in which event the timing of the recognition in profit or loss depends on the nature of the hedge relationship.

Embedded derivatives

During 2010 and 2009, the Group had no embedded derivative financial instruments.

Provisions

Provisions are recognised when the Group has a present obligation (legal or constructive) as a result of a past event and it is probable that an outflow of resources will be required to settle the obligation, and a reliable estimate can be made of the amount of the obligation. Provisions are reviewed at the end of each reporting period and adjusted to reflect the current best estimate. Where the effect of discounting is material, the amount of the provision is the present value of the expenditures expected to be required to settle the obligation. Where discounting is used, the increase in provisions that reflects the passage of time is recognized as interest expense.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Use of estimates in the preparation of the financial statements

The preparation of financial statements in conformity with International Reporting Financial Standards, as published by the International Accounting Standards Board requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, income and expenses and disclosure of contingencies. The significant areas of estimation used in the preparation of the accompanying financial statements relate to employee benefits, useful lives of property, plant and equipment, impairment of assets and determination of fair values of assets and liabilities, and estimated decommissioning costs. Future events may occur which will cause the assumptions used in arriving at the estimates to change. The effect of any changes in estimates will be recorded in the financial statements, when determinable.

Revenue recognition

Revenue is earned primarily from the sale of electricity to households, industrial and other customers within Croatia. These sales constitute the main source of the Group's operating income.

Revenue recognition is based on the Decision of the Croatian Government on the tariff Amounts from June 2008 and August 2009.

Interest income is recognised on an accrual basis, by reference to the principal settled and at the effective interest rate applied.

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES (continued)

Revenue from connection fees

Up to 1 January 2010 connection fees received from customers were deferred and recognised in income over the expected useful life of asset, i.e. connection fee. Such policy is still used for connection fees received before 1 January 2010.

As of 1 January 2010 Group has adopted IFRIC 18 Transfers of Assets from Customers.

IFRIC 18 clarifies the requirements of IFRSs for agreements in which an entity receives from a customer asset (item or property, plant and equipment or cash) that the entity must then use either to connect the customer to a network or to provide the customer with ongoing access to a supply of goods or services. When the item of property, plant and equipment transferred from a customer meets the definition of an asset the Company must recognize the asset in its financial statements.

As a result since 1 January 2010 the connection fees received from customers are recognized in the income when the fee is received and are not deferred over the period of 20 years as was the case in prior periods.

Segmental disclosures

The Group has fully adopted IFRS 8 Operating segments and presented operating segments disclosures required by Standard, since it has debt instruments which are traded in public market.

3. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES

Critical judgments in applying accounting policies

In the application of the accounting policies, which are described in Note 2, the management made certain judgments that had a significant impact on the amounts reported in the financial statements (irrespective of the underlying estimates referred to below).

These judgments are provided in detail in the accompanying notes. However, the critical judgments relate to the following areas:

Useful lives of property, plant and equipment

As described in Note 2, the Group reviews the estimated useful lives of property, plant and equipment at the end of each annual reporting period.

Fair value of financial assets and interest-rate swap

As described in Note 20, the management uses judgment to estimate whether trade and other receivables have suffered an impairment loss. The management believes that the carrying amount of the interest-rate swap approximates its fair value as disclosed in Note 26.

Provisions for environmental protection

The exact scope of activities or technologies to be applied has not been specified by the applicable laws or regulations. In determining the level of provisions for environmental protection and decommissioning, the management relies on the prior experience and its own interpretation of the current laws and regulations. Pursuant to Article 4.1 of the Law on Acknowledging the Contract between the Government of the Republic of Croatia and the Government of the Republic of Slovenia on Regulating the Status and other Legal Relations in Respect of Investments in, Exploitation and Decommissioning of, the Nuclear Power Plant Krško (Official Gazette No. 9/2002), the Croatian Government issued on 28 April 2006 a decree on the payment of the funds for the decommissioning and disposal of radioactive waste and consumed nuclear fuel of the NPPK.

The decommissioning costs of thermal power plants represent the discounted value of the estimated decommissioning costs of the Group's thermal power plants.

Over / under billed revenue adjustment

After analyzing a number of different methods of approximation (five – year average, a linear approximation, etc.), Management has decided that the most appropriate is a method of logarithmic regression is the most appropriate. The amount of losses on the network distribution is calculated using the percentage of the function of the logarithmic regression on the total amount of purchased power from the transmission network - the result of the losses of electricity distribution network in the current year in MWh.

The difference between the thus obtained size of losses and over/under billed revenue balance for the current year is calculated.

3. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES (continued)

Critical judgments in applying accounting policies (continued)

Over / under billed revenue adjustment (continued)

Such difference represents basis for calculation of over / under billed revenue and is multiplied by the average selling prices for households earned in the current year from those without a fixed monthly fee and the result is the difference that increases or decreases the revenues from selling electricity to households (note 21).

Impairment of non-current assets

The impairment calculation requires the estimate of the value in use of the cash generating units. Value in use is measured using the discounted cash flow projections. The most significant variables in determining cash flows are discount rates, time values, the period of cash flow projections, as well as assumptions and judgments used in determining cash receipts and expenditure. There were no impairments of assets of the Group that would result from the projections described above.

Availability of taxable profits against which the deferred tax assets could be recognised

A deferred tax asset is recognized only to the extent that it is probable that the related tax benefit will be realized. In determining the amount of deferred taxes that can be recognised are required, which are based on the probable quantification of time and level of future taxable profits, together with the future tax planning strategy. The carrying amounts of deferred tax assets at 31 December 2010 and 31 December 2009 amounted to HRK 159,429 thousand and HRK 120,351 thousand, respectively (see Note 9).

3. CRITICAL ACCOUNTING JUDGEMENTS AND ESTIMATES (continued)

Critical judgments in applying accounting policies (continued)

Actuarial estimates used in determining the retirement bonuses

The cost of defined benefits is determined using actuarial estimates. Actuarial estimates involve assumptions about discount rates, future salary increases and the mortality or fluctuation rates. Because of the long-term nature of those plans, there is uncertainty surrounding those estimates. Provisions for jubilee awards and retirement bonuses amounted to HRK 348,425 thousand and HRK 287,849 thousand at 31 December 2010 and 31 December 2009, respectively (see Note 27).

Consequences of certain legal actions

There are a number of legal actions involving the Group, which have arisen from the regular course of their operations. If there is a present obligation as a result of a past event (taking into account all available evidence, including the opinion of law experts) for which is probable that outflow of resources will be required to settle the obligation and if a reliable estimate can be made of the amount of the obligation, provisions are recorded (see Note 27).

Remeasurement of the Janaf shares and investment property at fair value

During 2010 and 2009, the Group remeasured the Jadranski naftovod shares and the investment properties at fair value.

In 2010 and 2009 fair value was made based on notification of Central clearing deposit company regarding open balances as of 31 December 2010 and 2009. Market value of Jadranski naftovod share as at 31 December 2010 was HRK 3,000 (2009: 2,826)

Gain resulting from the fair valuation of the investment property amount to HRK 19,865 thousands, while in 2009 loss resulting from fair valuation was in amount of HRK19,748 thousand (see notes 5 and 7).

Valuation of inventories

During 2010 based on estimation, Group has made value adjustment of obsolete inventories and materials (material with no transactions in previous 2 year) according to ageing structure in total amount of HRK 15,070 thousands (2009: 110,647 thousand).

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

4. SEGMENT INFORMATION

The Group generates income from its operations in a single geographical area – the Republic of Croatia.

The Group's reportable segments are separated as follows: electricity (generation, transmission, distribution and sale of electricity), heating (distribution and sale of heating power), and gas (distribution and sale of gas).

Each segment's operating profit or loss includes all revenue and expenses directly attributable to the reporting business segments. Information about segment financial income, expense and income tax is not provided on a segment level, as the segments are disclosed based on operating profit.

	Electricity		Heating		Gas		Group	
	2010	2009	2010	2009	2010	2009	2010	2009
	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000	HRK'000
Revenue	10,851,054	10,798,272	569,784	553,732	394,182	294,262	11,815,020	11,646,266
Other income allocated to segments	1,065,005	871,555	59,928	56,662	28,657	26,303	1,153,590	954,520
Income from operations	2,356,596	671,859	(142,592)	(104,388)	(3,091)	179	2,210,913	567,650
Net financial loss							(373,745)	(340,541)
Income tax							(401,802)	(72,687)
Net profit							1,435,366	154,422

Segment assets consist primarily of property, plant and equipment, receivables, cash and inventories. Segment liabilities consist of trade and other payables. Non-segment assets and liabilities consist of assets and liabilities that cannot be reasonably attributed to the reporting business segments.

Total unallocated assets include investments in NPPK, a part of property, plant and equipment, and unallocated financial assets. Total unallocated liabilities include long-term loans, short-term loans and various other liabilities.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

4. SEGMENT INFORMATION (continued)

	Total segment assets		Total segment liabilities	
	2010 HRK'000	2009 HRK'000	2010 HRK'000	2009 HRK'000
Electricity	28,409,155	29,963,915	6,995,442	6,953,885
Heating	1,097,458	1,036,394	220,139	237,636
Gas	319,336	286,987	180,345	158,621
Unallocated	3,795,028	1,423,758	6,545,198	7,112,798
Total Group	33,620,977	32,711,054	13,941,124	14,462,940

Information on the largest customers

Activity from sales of electricity in 2010 amounts HRK 10,851,054 thousands (HRK 10,798,272 thousands in 2009).

Activity from sale of heating energy in 2010 amounts HRK 569,784 thousands (HRK 553,732 thousands in 2009).

Activity from sale of gas in 2010 amounts HRK 394,182 thousands (HRK 294,262 thousands in 2009).

Territorial business analysis

The Group operates in Europe, with countries that are members of the European Union and other countries that are not members of the European Union.

Below is presented territorial analysis of revenue that Group generated from active parts of the businesses with external buyers of electric energy:

	2010 HRK'000	2009 HRK'000
Croatia	10,600,969	10,461,750
European Union members	185,373	323,870
Other countries non European Union members	64,712	12,652
	10,851,054	10,798,272

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

5. OTHER OPERATING INCOME

	2010	2009
	HRK'000	HRK'000
Income from assets received free of charge	218,769	194,762
Services rendered	150,423	239,454
Service for connection to network	139,245	-
Subsequent collection of receivables previously provided against Capitalised assets	134,531	91,033
Late-payment interest	112,592	147,151
Income from sale of materials	80,126	68,808
Income from electricity in transit – foreign	48,512	20,411
Foreign exchange gain on loans	45,715	30,049
Reversal of long-term provisions for retirement benefits and jubilee awards	25,707	-
Income from sale of cross – border transmission capacity	24,449	18,356
Gains on fair valuation of investment properties	19,865	30,032
Income in respect of the electricity bill reminders	19,462	-
Reversal of long-term provisions – court costs	18,144	17,523
Income in respect of court costs on claims	18,144	13,816
Income from reversal of long-term decommissioning provision	7,673	9,844
Income from balancing energy	4,706	620
Recovery of receivables previously written off	4,067	-
Income from sale of tangible assets	2,585	8,208
Inventory surplus – fixed assets	1,889	7,163
Other	870	406
	<u>72,676</u>	<u>56,884</u>
	<u>1,153,590</u>	<u>954,520</u>

In 2010 the Group generated income from services for connection to a network in amount of HRK 139,245 thousand based on IFRIC 18 (Transfer of assets from customers) that in Republic of Croatia came into force as of 1 January 2010 (Official Gazette No. 18/2010). The effect of adoption of IFRIC 18 as of 1 July 2009 on financial statements for year ended 31 December 2009 has not been done.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

6. STAFF COSTS

	2010	2009
	HRK'000	HRK'000
Net salaries	1,134,137	1,157,790
Taxes and contributions	761,068	796,560
	<u>1,895,205</u>	<u>1,954,350</u>

Total staff costs:

	2010	2009
	HRK'000	HRK'000
Gross salaries	1,895,205	1,954,350
Reimbursement of costs to employees (Note 7)	156,673	147,718
Employee benefits (Note 7)	77,055	89,030
	<u>2,128,933</u>	<u>2,191,098</u>

Directors' and executives remuneration:

	2010	2009
	HRK'000	HRK'000
Gross salaries	6,483	7,086
Pension contributions	1,424	1,498
Other receipts	1,023	1,091
	<u>8,930</u>	<u>9,675</u>

Reimbursement of costs to employees includes commutation allowances in the amount of HRK 80,158 thousand (2009: HRK 88,867), daily allowances and travelling expenses in the amount of HRK 17,636 thousand (2009: HRK 16,870 thousand), additional health insurance amounting to HRK 17,209 thousand (2009: HRK 21,461 thousand), receipts based on tax inspection in the amount of HRK 15,561 and other similar expenses.

Employee benefit costs include benefits under Collective Agreement and consist primarily of Christmas and Easter allowances, solidarity support, jubilee awards, family separation allowances and fieldwork bonuses, holiday bonuses, child benefits and other in the total amount of HRK 54,424 thousand (2009: HRK 46,392 thousand).

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

7. OTHER OPERATING EXPENSES

	2010	2009
	HRK'000	HRK'000
Maintenance costs (service and material)	645,098	578,792
General and administrative expenses	380,020	453,201
Provisions for doubtful receivables	332,139	275,006
Gas costs	355,869	256,454
Other employee benefits (Note 6)	156,673	147,718
Cost of material	118,136	131,858
NPPK – decommissioning expense in accordance with Government decision	103,854	104,506
Contributions to the State	99,264	104,073
Provisions for retirement bonuses and jubilee awards	86,762	60,964
Litigation provisions	75,986	105,689
Other material employee's rights (Note 6)	77,055	89,030
Distributions and concession for water	74,601	63,803
Fee for the usage of power plant facilities	66,115	52,564
Accrual for unused vacation days	64,477	-
Provision for NPPK de-commissioning costs	53,838	-
Provisions according to contracts for damages	52,179	28,621
Purchase value of sold materials	40,710	17,233
Provision for investment in HE Lešće	39,286	-
Damages and indemnities	37,449	9,643
Calculation and collection costs	34,823	36,647
Fee for environmental protection	27,299	48,943
Insurance premiums	24,860	25,045
Provision for delivered electric energy from wind power plants	22,031	-
Write-off of tangible assets	21,462	79,310
Provision for inventory	15,070	110,647
Write-off of non claimed receivables	11,249	16,201
Development costs	9,229	13,109
Information costs	6,282	7,719
Decommissioning provision for thermal power plant	5,549	5,252
Fees and subscription	3,099	4,084
Foreign exchange loss on loans	-	28,772
Losses on fair value of investment properties	-	19,748
Other	11,916	50,844
	<u>3,052,380</u>	<u>2,925,476</u>

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

8. FINANCIAL REVENUE AND COSTS

	2010	2009
	HRK'000	HRK'000
Financial income		
Foreign exchange gains	50,999	73,572
Interest expense	14,480	7,529
Total financial income	65,479	81,101
Finance costs		
Interest expense	(272,471)	(358,907)
Foreign exchange losses	(167,029)	(82,419)
Amortization of deferred interest	(3,858)	(3,686)
Fair value of interest swap	(1,871)	(2,271)
Financial expenses	(445,229)	(447,283)
Capitalised interest	6,005	25,641
Total financial expenses	(439,224)	(421,642)
Net finance loss	(373,745)	(340,541)

9. INCOME TAX

	2010	2009
	HRK'000	HRK'000
Current taxes	440,880	126,470
Deferred tax expense/(income) relating to the origination and reversal of temporary differences	(39,078)	(53,783)
Income tax expense	401.802	72.687

Adjustments to deferred tax assets were as follows:

	2010	2009
	HRK'000	HRK'000
Balance at 1 January	120,351	66,568
Reversal of deferred tax assets	(21,345)	(1,285)
Deferred tax assets recognised	60,423	55,068
Balance at 31 December	159,429	120,351

Deferred tax assets have arisen on provisions for jubilee awards and regular retirement benefits not recognised for tax purposes, provisions for trade debtors – households and provisions for legal actions.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

9. INCOME TAX (continued)

The reconciliation between income tax and profit reported in the income statement is set out below:

	2010	2009
	HRK'000	HRK'000
Profit before taxation	1,837,168	227,109
Income tax at the applicable rate of 20%	367,433	45,421
Tax non-allowable expense/(income)	(157,509)	(52,527)
Tax effect of permanent differences	39,078	53,783
Tax effect of losses brought forward	-	(90,089)
Tax effect of Group entities operating with loss	152,800	116,099
Tax expense for the year	401,802	72,687

The Group and its subsidiaries are subject to income tax separately, according to the tax laws and regulations of the Republic of Croatia. Other subsidiaries in the Group reported total tax losses of HRK 626,588 thousand (2009: HRK 536,237 thousand), while the Group recorded a total income tax expense of HRK 440,880 thousand (2009: HRK 126,470 thousand) and reported deferred tax assets in the amount of HRK 39,078 thousand for the current year and HRK 53,783 thousand for prior years.

Tax losses are available for carry forward and offsetting against the tax base in future taxation periods until their expiration as prescribed by law, which is 5 years following the year in which the tax losses were incurred.

Tax losses reported by the Group and their expiry are presented below:

Year of loss origination	Total tax loss reported by the Group	Year of expiry
2006	60,664	2011.
2007	102,889	2012.
2008	194,136	2013.
2009	116,099	2014.
2010	152,800	2015.
	626,588	

As of 31 December 2010 and 2009 the Group did not recognise deferred tax assets arising from tax losses carried forward at certain subsidiaries because the availability of future taxable profit against which the unused tax losses can be utilized is not certain.

The Croatian Tax Authorities have not performed a review of the income tax returns of the Group and its subsidiaries. In accordance with local regulations, the Tax Authority may at any time inspect the books and records of any Group company within 3 years following the year in which the tax liability is reported and may impose additional tax assessments and penalties. The Group management is not aware of any circumstances that may give rise to a potential material liability in this respect.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

9. INCOME TAX (continued)

The following table summarizes the movement in deferred tax assets during the year:

HRK'000	Value adjustment of inventory	Provisions for jubilee and retirement benefits	Litigation provision	Depreciation at rates above statutory rates	Other	Total
At 1 January 2009	-	55,864	7,708	2,434	562	66,568
Credited to profit and loss for the year	21,675	9,299	9,972	1,085	11,752	53,783
At 31 December 2009	21,675	65,163	17,680	3,519	12,314	120,351
Credited to profit and loss for the year	4,324	12,381	(13,130)	1,335	34,168	39,078
At 31 December 2010	25,999	77,544	4,550	4,854	46,482	159,429

Following table summarizes movement of deferred tax liability recognised in respect of fair valuation of assets available for sale:

	31 December 2010
	In HRK thousands
Gain on fair valuation of assets available for sale (see Note 15)	9,373
Deferred tax liability recognised on gain from fair valuation at 20%	(1,874)
Gain on fair valuation of assets available for sale recognized in other comprehensive income	7,499

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

10. PROPERTY, PLANT AND EQUIPMENT

HRK'000	Land and buildings	Fixtures and equipment	Assets under construction	Total
COST				
At 1 January 2009	32,991,951	30,466,989	3,370,610	66,829,550
Restatement 01 January 2009	(13,998)	-	-	(13,998)
Transfers	14,853	2,635	2,547	20,035
Additions	5,462	73,814	2,279,898	2,359,174
Transfers from assets under construction	694,693	1,789,766	(2,496,205)	(11,746)
Capitalized borrowing costs	-	-	35,630	35,630
Inventory surplus	34	711	-	745
Disposals	(68,202)	(170,991)	(62,186)	(301,379)
At 31 December 2009	33,624,793	32,162,924	3,130,294	68,918,011
Restatement 01 January 2010	(211)	211	-	-
Transfers	(747)	(75)	428	(394)
Additions	4,997	75,362	1,579,319	1,659,678
Transfers from assets under construction	604,745	1,027,172	(1,657,440)	(25,523)
Capitalized borrowing costs	-	-	7,161	7,161
Inventory surplus	400	512	-	912
Disposals	(61,172)	(134,031)	(13,446)	(208,649)
At 31 December 2010	34,172,805	33,132,075	3,046,316	70,351,196
ACCUMULATED DEPRECIATION				
At 1 January 2009	20,513,148	19,718,279	-	40,231,427
Restatement at 01 January 2009	(2,161)	-	-	(2,161)
Transfers	14,344	17,227	-	31,571
Charge for the year	685,989	975,808	-	1,661,797
Value adjustment of additions	271	4,127	-	4,398
Eliminated on disposal	(60,084)	(162,706)	-	(222,790)
Inventory surplus	20	656	-	676
At 31 December 2009	21,151,527	20,553,391	-	41,704,918
Restatement at 01 January 2010	(182)	182	-	-
Transfers	(764)	1,217	-	453
Charge for the year	689,028	1,007,579	-	1,696,607
Eliminated on disposal	(59,728)	(128,314)	-	(188,042)
Inventory surplus	263	311	-	574
At 31 December 2010	21,780,144	21,434,366	-	43,214,510
CARRYING AMOUNT				
At 31 December 2010	12,392,661	11,697,709	3,046,316	27,136,686
At 31 December 2009	12,473,266	11,609,533	3,130,294	27,213,093

10. PROPERTY, PLANT AND EQUIPMENT (continued)

Disposals from capital work in progress during 2010 in the amount of HRK 13,446 thousand (2009: HRK 62,118 thousand) represent write-offs based on the estimate of management that no future economic benefits will be derived from those assets.

Due to political developments in Croatia since 1990, certain local municipal land registers have not been fully established. The company is in the process of registering, through the local courts in Croatia, its title to land and buildings. To date, no claims have been made against the company concerning its title to these assets.

The Group has pledged property, plant and equipment having a carrying amount of approximately HRK 560,384 thousand (2009: HRK 693,376 thousand) to secure the banking facilities provided to TE Plomin d.o.o.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

11. INTANGIBLE ASSETS

	HRK'000
COST	
At 1 January 2009	564,425
Transfers	(32,161)
Additions	12,197
Disposals	(1,586)
At 1 January 2010	542,875
Transfers	140
Additions	25,937
Disposals	(221)
At 31 December 2010	568,731
ACCUMULATED AMORTISATION	
At 1 January 2009	485,775
Transfers	(31,571)
Charge for the year	26,764
Disposals	(1,764)
At 1 January 2010	479,204
Transfers	57
Charge for the year	24,678
Disposals	(218)
At 31 December 2010	503,721
CARRYING AMOUNT	
At 31 December 2010	65,010
At 31 December 2009	63,671

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

12. INVESTMENT PROPERTIES

Investment properties comprise properties held for the purpose of generating earnings from rental and or capital appreciation, and are carried at the management's best estimate of fair value. The fair value comprises the estimated market price at the end of reporting period. All the investment properties are owned by the HEP d.d.

At fair value	31 December 2010	31 December 2009
	HRK'000	HRK'000
Fair value	202,467	211,074
Depreciation charge for the year	(187)	(189)
Net gains on remeasurement at fair value	19,865	(19,748)
Other changes	949	11,330
Closing balance at fair value	223,094	202,467

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

13. PREPAYMENTS FOR PROPERTY, PLANT AND EQUIPMENT

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Electricity facilities on the Croatian highways - Hrvatske Autoceste	300,000	300,000
JSC Tehnopromexport –TE Sisak	56,530	59,068
Litostroj Slovenija	4,457	8,447
Končar Inženjering d.d. – HE Lešće	1,249	5,169
Voith Siemens Austria	3,978	4,955
Ingra d.d. – HE Lešće	307	1,692
Konstruktor Inženjering	432	1,081
Others	19,102	22,668
	<u>386,055</u>	<u>403,080</u>

In December 2006, the Group advanced a payment to Hrvatske autoceste d.o.o. for the purpose of acquisition of electricity facilities on the Croatian highways within 2 years from the advance payment.

As of the date of these financial statements, the facilities were not transferred to the Group, and an agreement was concluded with Hrvatske autoceste d.o.o. in December 2009, under which the deadline for the takeover of the electricity facilities by the Group has been prolonged for another 2 years.

The Group is the beneficial owner of these facilities, as it uses those assets for their intended economic purpose which is to supply electricity to customers.

As of the date of issue of these financial statements, the Group has not classified these assets by type, and the economic effect of transfer of these assets from prepayments to tangible assets has not been calculated as well as the related depreciation.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

14. INVESTMENT IN THE NUCLEAR POWER PLANT KRŠKO

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Opening balance	1,605,593	1,609,598
Positive / (negative) exchange difference (charged to capital reserves)	17,354	(4,005)
	<u>1,622,947</u>	<u>1,605,593</u>

Investment background

The legal status of the Nuclear Power Plant Krško ("NPPK") was regulated by inter-republic agreement dating back to 1970 and various agreements between the founders from 1974 and 1982. Pursuant to the stated agreements, the Company had a 50% interest in the NPPK in Slovenia, the other 50% was held by ELES GEN d.o.o., Ljubljana, the legal successor of the Slovenian power utility.

In 1998, the Slovene government passed a decree transforming the NPPK into a public company, Nuclear Power Plant Krško d.o.o. ("NPPK"), and nationalizing the nuclear power plant. Additionally, due to operational disputes, which include disagreements on energy prices to be charged and approval of annual budgets, the supply of power to HEP d.d. from NPPK was cut on 30 July 1998 and was not restored until 19 April 2003.

In late 2001, the Governments of the Republic of Croatia the Republic of Slovenia signed an agreement governing the status and other legal relations in connection with their respective investment in NPPK, usage and decommissioning, as well as a partnership agreement between HEP d.d. and ELES GEN. This agreement was ratified by the Croatian parliament during 2002, and it come into effect as at 11 March 2003, following the ratification by the Slovene parliament on 25 February 2003.

The agreement acknowledges the ownership rights of HEP d.d. in the newly formed company, Nuklearna elektrana Krško d.o.o. ('NPPK') in respect to its 50% holding in NPPK, which were previously denied. Both parties have agreed to extend the useful life of the power plant at least to the year 2023. The agreement also regulates that the produced electricity is supplied 50:50 to both contracting parties, and that the price of the electricity supplied is determined based on total production cost.

HEP d.d. started to receive electricity from NPPK on 19 April 2003, and expects to receive 2,550 GWh annually up to 2023, representing 16% of electricity consumption in Croatia.

The investment in NPPK is accounted as associate using the equity method and amounts to HRK 1,622,947 thousand, as HEP does not have joint control over NPPK. The positive foreign exchange difference in the amount of HRK 17,354 thousand arisen on retranslation of the Company's net investment was charged to capital reserves.

14. INVESTMENT IN THE NUCLEAR POWER PLANT KRŠKO (continued)

By the end of 2003, the provisions of the agreement have been implemented according to which HEP d.d. and NPPK waive mutual receivables for damages and withdraw all claims arising there from up to 30 June 2002, including the disputed liabilities for electricity purchase and amounts due with respect to the previously calculated contribution for financing the decommissioning of the power plant and funds to cover the losses from previous years. After implementing the changes, the capital of NPPK as at 31 December 2003 amounted to SIT 84.7 billion (approximately: HRK 2.8 billion). Still there are some outstanding off-balance receivables from HEP d.d. to NPPK and Slovenia from the past, which do not have any influence on the current business relations.

Current status

According to the above stated agreement, the decommissioning of NPPK will be a joint obligation of both parties. Each party will provide half of the funds necessary to prepare the decommissioning plan and to cover the cost of implementation of the plan. In addition, each party will form a separate fund to allocate the funds for this purpose in the amounts estimated by the decommissioning plans. When the Croatian parliament accepted the decommissioning program (including radioactive waste disposal), Once the Croatian Parliament has adopted the decommissioning program (including radioactive waste disposal), the establishment of a Croatian fund for gathering decommissioning funds and for nuclear waste management is expected. The amount of annual payments to be made to the Fund will be determined taking into account the decommissioning program. From 2004 to 2010, the Group disclosed radioactive waste disposal and decommissioning provisions in the amount of HRK 964,917 thousand, and paid HRK 959,893 thousand on a separate account in the period from 2006 to 2010. Provision as of 31 December 2010 amounts to HRK 5,024 thousands which in fact represents current portion (Note 33).

14. INVESTMENT IN THE NUCLEAR POWER PLANT KRŠKO (continued)

The investment in NPPK is accounted for using the equity method and amounts to HRK 1,622,947 thousand. The positive foreign exchange differences arising on recalculating the capital from the Group's investment amounting to HRK 17,354 thousand (2009: negative foreign exchange difference arising on recalculating the capital from the company's investment amounting to HRK 4,005 thousand) was charged to capital reserves.

Extracted financial information

The following table presents the financial information extracted from the financial statements of NPPK as at 31 December 2010 and 2009:

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Property, plant and equipment	3,089,065	3,063,234
Capital and reserves	3,245,896	3,211,186
Gross sales	1,214,576	1,120,485
Net profit	-	-
Cash flows from operating activities	313,211	352,970

15. INVESTMENT IN TPP PLOMIN

In November 1996, HEP d.d. entered into a Joint Venture Agreement with RWE Energie Aktiengesellschaft, Germany ('RWE') regarding the completion and operation of TPP Plomin II. Consequently, a joint venture, TE Plomin d.o.o. ('Plomin') was formed in December 1996, with each partner holding 50 % of the equity of the new entity. A number of agreements were entered into, which regulate the relationship between the joint venture partners and their respective relationships with the new groups.

In accordance with the 1996 Asset Contribution Agreement, HEP d.d. contributed property, plant and equipment previously acquired for the project valued (by Croatian valuation experts) at DEM 50,000 thousand (HRK 179,138 thousand) as a contribution in kind to Plomin. Of this amount, HRK 50 thousand was allocated as share capital, while HRK 179,088 thousand was allocated to reserves.

In accordance with the Joint Venture Agreement, RWE contributed an equal amount of cash over the period of construction. The initial cash contribution of HRK 50 thousand was allocated as share capital and the remainder to reserves. The RWE capital contributed is distributed back to RWE over the term of the joint venture of 15 years, starting from the date of operation of the power plant at 30 April 2000.

In 2010 the distribution of RWE invested equity amounted to HRK 12,382 thousand (2009: HRK 12,677 thousand). The remaining undistributed RWE invested capital amounted to HRK 63 million at 31 December 2010 (2009: HRK 75 million).

Under the Statute of Plomin, RWE is entitled to an annual return during the term of the joint venture of 14% to 17% on invested capital (based on the actual number of hours of peak exploitation during the year). The invested capital includes RWE undistributed equity contribution as the unpaid portion of the accrued cumulative interest earned on investment during construction.

During the period of construction, the accrued cumulative interest on the RWE capital amounted to HRK 54,717 thousand (EUR 7,536 thousand) and is payable on a straight-line basis during the period of exploitation. At 31 December 2009, accrued undistributed interest amounted to HRK 16,076 thousand (2009: HRK 19,577 thousand).

The RWE annual return on invested capital, effectively a preferred dividend, is paid out from net profit of Plomin. The rate for 2010 and 2009 is 17% and 16%. The amount paid out in 2010 in respect of 2009 profits was HRK 15,674 thousand and in 2009 HRK 19,442 thousand in respect of 2008 profits.

These distributions have priority to HEP d.d. interest in the results of the joint venture and any other payments to HEP d.d.. Since HEP d.d. share has been used to pay RWE interest on capital since 2000, HEP d.d. has not realized any portion of profits earned by Plomin.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

15. INVESTMENT IN TPP PLOMIN (continued)

The joint venture partners entered into a number of agreements necessary for power plant operations, including: operation and maintenance agreements, a joint use and supply agreement and a power purchase agreement ('PPA'). The PPA agreement regulates the sale of electric energy to the Group by Plomin d.o.o. HEP d.d. is obliged to purchase all energy produced by TE Plomin d.o.o. at prices calculated in accordance with specified formulas in the PPA, which are designed to cover all costs of operations of Plomin, and ensure the guaranteed return on capital to RWE.

In these financial statements, the Group has presented its interest in TE Plomin using the method of full consolidation.

	2010	2009
	HRK '000	HRK '000
Opening balance of the non-controlling share	91,409	106,821
Interest payment	(12,382)	(12,677)
Dividend payment	(16,583)	(19,442)
Increase for current year profit	14,063	18,578
Correction of tax liabilities through retained earnings	-	(1,995)
Exchange differences	486	124
Closing balance	76,993	91,409

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

16. LONG-TERM LOAN RECEIVABLES AND DEPOSITS

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Loans given	1,318	1,794
Current portion of loans given	<u>(135)</u>	<u>(311)</u>
Long-term portion	<u>1,183</u>	<u>1,483</u>

Loans given to third parties

	Year loan approved	Repayment period	Loan amount	31 December 2010	31 December 2009
				HRK'000	HRK'000
Town of Pregrada	2006	10 years	1,358	950	914
Did d.o.o.	2007	4 years	1,010	368	880
Total				<u>1,318</u>	<u>1,794</u>
Current portion				<u>(135)</u>	<u>(311)</u>
Non-current portion				<u>1,183</u>	<u>1,483</u>

17. INVESTMENTS AVAILABLE FOR SALE AND OTHER INVESTMENTS

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Investments available for sale	162,170	152,797
Other investments	<u>210</u>	<u>200</u>
	<u>162,380</u>	<u>152,997</u>

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

17. INVESTMENTS AVAILABLE FOR SALE AND OTHER INVESTMENTS (continued)

Changes in investments available for sale are presented below:

	2010	2009
	HRK '000	HRK '000
Beginning balance	152,797	151,374
Fair value of Jadranski Naftovod d.d.	9,373	1,423
	162,170	152,797
	2010	2009
	HRK '000	HRK '000
Investment in securities:		
Jadranski Naftovod d.d.	161,943	152,570
Viktor Lenac d.d.	220	220
Đuro Đaković d.d.	5	5
Kraš d.d.	2	2
	162.170	152,797
Other investments		
Geopodravina d.o.o.	200	200
LNG Hrvatska d.o.o.	10	-
	162,380	152,997

In December 2008, HEP d.d. acquired 53,981 shares of Jadranski Naftovod d.d. under a decision of the Croatian Government, with a nominal value of HRK 2,700 per share i.e. the total nominal value of HRK 145,748,700. According to the Management Decision, the Jadranski Naftovod shares were designated as available for sale. The shares were subscribed at the Central Depository Agency on 19 March 2009.

17. INVESTMENTS AVAILABLE FOR SALE AND OTHER INVESTMENTS (continued)

In 2010 and 2009 fair value was determined by notification of Central clearing deposit company of balance as of 31 December. Market value of Jadranski naftovod share as of 31 December 2010 is HRK 3,000 (2009: HRK 2,826). Fair value of investment in Jadranski naftovod as of 31 December 2010 is HRK 9,373 thousands (2009: 1,423 thousands).

On 1 June 2010 HEP d.d. and Plinacro concluded the Articles of Incorporation of LNG Hrvatska d.o.o., a liquefied natural gas company. The share capital of the company amounts to HRK 20 thousand, with HEP d.d. and Plinacro each holding 50 percent of the equity shares.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

18. OTHER LONG TERM ASSETS

	2010	2009
	HRK'000	HRK'000
Housing loan receivables	42,890	54,035
Energetic efficiency receivables – long term part	51,930	43,391
Calculated interest – RWE	16,078	19,577
Other long term asset	75	103
	<u>110,973</u>	<u>117,106</u>

Prior to 1996, the Group had sold apartments it owned to its employees, the sale of which were governed by the laws of the Republic of Croatia. This property was generally sold on credit, and the related housing receivables, which are secured and bear interest at rates below market, are repayable on a monthly basis over periods of 20-35 years. Receivables for sold flats were transferred to new subsidiaries as of 1 July 2002. The housing receivables are shown in the financial statements at their discounted net present values, determined using an interest rate of 6.3 %. The state payable which represents 65% of the value of sold apartments is recorded in non-current liabilities to the state (Note 25). The receivables are secured by mortgages over the sold apartments.

According to association regulation, on all funds invested by RWE Power interest rate that in period of construction amounted to 17% interest is calculated. Calculated interest in amount of EUR 7,536 thousands, calculated in HRK 55,653 thousands is completely recorded as deferred expense depreciated over 15 years by linear method.

Repayment of interest is done along with repayment of invested funds from RWE Power and it started after electric power plant was finished. In 2010 total repaid amount was EUR 502 thousands or calculated in HRK 3,650 thousands (in 2009 EUR 502 thousands, recalculated in HRK 3,737).

As at 31 December 2010 deferred expense for interests amounted to EUR 2,177 thousands or recalculated to HRK 16,078 thousands (in 2009 EUR 2,679 thousands, recalculated in HRK 19,577 thousands). Exchange differences are represented through finance income or expenses for the year in which they occurred.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

19. INVENTORIES

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Inventories of fuel and other material	748,065	553,996
Electric materials	162,486	171,684
Spare parts	175,536	99,099
Construction material	83,211	84,454
Other inventories	73,090	169,345
Allowance for obsolete materials and spare parts	<u>(125,717)</u>	<u>(110,647)</u>
	<u>1,116,671</u>	<u>967,931</u>

During 2010 Group estimated provision for obsolete inventories of materials (material which had no transactions in last 2 years) in accordance with ageing structure which resulted with value in total amount of HRK 15,070 thousands (2009: 110,647 thousand).

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

20. TRADE RECEIVABLES

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Electricity – Corporate customers	1,355,919	1,109,074
Electricity – Households	336,814	270,576
Heating, gas and services	446,462	444,020
Foreign sales	73,461	23,386
Connection to transmission network	33,131	-
Other	59,951	49,818
	2,305,738	1,896,874
Allowance for bad and doubtful receivables	(575,410)	(402,885)
	1,730,328	1,493,989

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

20. TRADE RECEIVABLES (continued)

Ageing analysis of receivables not impaired is as follows:

	31 December 2010		31 December 2009
	HRK'000		HRK'000
Not yet due	1,044,409	Not yet due	775,460
0-30 days	347,291	0-60 days	343,778
31-60 days	145,786	61-90 days	109,517
61-90 days	64,544	91-120 days	49,647
91-180 days	68,461	121-365 days	152,228
181-365 days	50,294	Over 365 days	63,359
Over 365 days	9,543		
	<u>1,730,328</u>		<u>1,493,989</u>

In 2010 the Group changed its estimates of receivable ageing categories and allowance percentages. The effect of the change in the estimates reflected through an decrease of provisions for 2010 by HRK 10,630 thousand.

Movements in impairment allowance were as follows:

	31 December 2010	31 December 2009
	HRK'000	HRK'000
At 1 January	<u>402,876</u>	<u>239,989</u>
Provisions for potential losses on receivables and interest on receivables (Note 7)	332,139	275,006
Reversal of prior-year provisions	(25,074)	(21,086)
Amounts collected (Note 5)	(134,531)	(91,033)
At 31 December	<u>575,410</u>	<u>402,876</u>

Management conducts a value adjustment of bad and doubtful receivables based on a review of the overall ageing structure of all receivables and based on a review of significant individual amounts involved in the receivables.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

21. OTHER SHORT-TERM RECEIVABLES

	31 December 2010	31 December 2009
	HRK'000	HRK'000
VAT receivable	27,560	19,555
Advances for working capital	26,196	18,865
Receivables from the State in respect of employees	6,403	7,950
Interest receivable	3,564	2,714
Demand and time deposits	1,735	8,362
Accrued electricity sales – households	380	87,058
Income tax prepayments	-	5,750
Receivables for Government bonds	-	22,641
Other short-term receivables	78,226	52,564
	<u>144,064</u>	<u>225,459</u>

The adjustment to the household electricity sales at 31 December 2010 has been determined using a logarithmic curve using grid losses of 8.74 percent, whereas the grid loss percentage used in the calculation for the year ended 31 December 2009 was 8.46 percent. The above-mentioned percentage change resulted in a decrease in receivables and revenue in amount of HRK 86.6 million compared to the prior year.

22. CASH AND CASH EQUIVALENTS

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Current accounts - HRK	71,510	61,810
Current accounts – Foreign	27,352	22,436
Current accounts for special purposes	5,710	11,407
Petty cash registers – HRK	287	418
Deposits due till 90 days	559,800	13,865
Daily deposits	97,498	33,898
	<u>762,157</u>	<u>143,834</u>

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

23. CAPITAL AND RESERVES

The original registration of share capital on 12 December 1994 was made in German Marks (DEM 5,784,832 thousand). On 19 July 1995, the share capital was reregistered in Croatian Kuna in the value of HRK 19,792,159 thousand. The share capital consists of 10,995,644 ordinary shares, with a nominal value of HRK 1,800 each.

The value adjustment of the investment in NPPK in respect of exchange differences was charged to equity. Exchange differences in NPPK as of 31 December 2010 amounted to HRK 131,472 (HRK 17,354 thousands in 2010, HRK 4,005 thousands in 2009).

Retained earnings in the amount of HRK 816,246 thousand comprise prior year profits in the amount of HRK 118,245 thousand, transferred loss in the amount of HRK 723,302 thousands, profit for the year in the amount of HRK 1,421,303 thousand. The non-controlling interest attributable to RWE amounts to HRK 76,993 thousand of which HRK 14,063 thousand represent dividends attributable to the foreign equity holder.

Capital reserves

	31 December 2010 HRK'000	31 December 2009 HRK'000
Opening balance of reserves	(2,038,472)	(1,891,069)
Transfer from retained earnings	1,008,073	-
Exchange differences – NPPK	17,354	(148,826)
Fair valuation of shares	7,499	1,423
	<u>(1,005,546)</u>	<u>(2,038,472)</u>

Retained earnings

	31 December 2010 HRK'000	31 December 2009 HRK'000
Opening balance	403,018	267,174
Correction of opening balance	(2)	-
Transfer to reserves	(1,008,073)	-
Profit for the year	1,421,303	135,844
	<u>816,246</u>	<u>403,018</u>

Based on General Assembly decision dated from June 30,2010 about distribution of profits from 2009 and retained earnings from prior year transfer in amount of HRK 1,008,073 thousand was done to cover negative reserves from previous years.

On 2 April 2011, the Government of the Republic of Croatia adopted a decision on the distribution of profit, that a minimum of half of the current year's profit of companies owned by the Republic of Croatia that operate with profit should be distributed. The decision should be ratified in the General Shareholders' Meeting of the Company.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

24. NON-CURRENT BORROWINGS

	Interest rates	31 December 2010 HRK'000	31 December 2009 HRK'000
Domestic bank borrowings	EURIBOR+ (1.00%-6.35%)	1,040,610	1,062,199
Foreign bank borrowings	EURIBOR+ (0.50%-4.74%)	3,010,835	2,929,555
Liabilities to domestic companies	EURIBOR+ 1.95%	4,661	13,835
Loan from RWE		12,369	19,577
Rescheduled debt		-	36,048
Total long-term borrowings		4,068,475	4,061,214
Current portion		(1,184,921)	(947,747)
Long-term portion		2,883,554	3,113,467

Loans from domestic banks are secured by bills of exchange and promissory notes. Loans from foreign banks are partly secured by state guarantees (loan for the project of special state care, and IBRD loan) and total assets of Plomin.

During 2010, the following loan facilities, agreed in previous years, were fully utilised:

- EBRD loan (EUR 24 million), for the purpose of the Termal Power Generation Project: HRK 38,368 thousand utilized in 2010;
- EBRD loan (EUR 4.4 million), for the Energy Efficiency Project: HRK 1,745 thousand utilized in 2010;
- Club loan (EUR 125 million), for the Capital Investment Project – Block C of the TPP Sisak: HRK 72,909 thousand utilized in 2010.

Unutilized balances represent the loan facility of KfW Entwicklungsbank in the amount of EUR 50,000,000 for financing the projects of the subsidiaries HEP ESCO and HEP Renewable Energy Sources. The key lending terms and conditions are as follows: utilisation period of 5 years; quarterly repayment of the loan principal over a period of 10 years following the expiry of the utilization period. The amount drawn under the KfW loan at 31 December 2010 was EUR 470,000, i.e. the unused loan funds amounted to EUR 49,530,000.

As the unfavourable economic trends in Croatia throughout 2010 prevented the utilization of the loan, intensified draw downs are expected in 2011. At the time of the conclusion of the agreement with KfW, which was in late 2008, a Financial Grant Agreement was concluded with the Government of the Federal Republic of Germany, under which Hrvatska elektroprivreda received a GEF grant in the amount of EUR 0.6 million. The total balance utilized as of 31 December 2010 was EUR 0.3 million.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

24. NON-CURRENT BORROWINGS (continued)

To finance investments and operations in 2010, HEP d.d. signed two bilateral long-term loan agreements during the year in the amount of EUR 10 million and EUR 100 million with SG- Splitska banka d.d. and Deutsche bank, respectively, such loans being guaranteed by the Government of the Republic of Croatia. The loans mature in 5 years..

Liabilities to domestic and foreign companies represent mainly extended payment terms for the purchases of tangible assets. If no repayment deadline has been specified in the underlying agreement any such liability is included within long-term liabilities.

The annual principal repayment schedule for the following five years is as follows:

	Amount
2011.	1,184,921
2012.	1,152,849
2013.	784,028
2014.	342,016
2015.	157,605
After 2015.	<u>447,056</u>
Total	<u>4,068,475</u>

The covenants, as defined in the applicable loan agreements, specifically require the Group to meet certain prescribed levels of the following ratios based on consolidated financial statements: operating ratio, debt service coverage, internal cash generation, tangible net worth capital, and net borrowing.

The analysis of long-term borrowings in various foreign currencies is provided below (in '000):

Currency	31 December 2010	31 December 2009
USD	-	7,083
EUR	549,223	548,245
Rescheduled debt		

The status of rescheduled debt is presented below:

	2010	2009
Rescheduled London Club debt	-	36,048
Total rescheduled debt	<u>-</u>	<u>36,048</u>

24. NON-CURRENT BORROWINGS (continued)

London Club Debt

During 2010 Company repaid last two instalments in accordance with long term rescheduled loans for NPPK – London Club Debt series “A” which amounted to USD 77,579,248, and ZERC –London club – series „A“ Splitska bank in amount of USD 335,082.

By repayment of mentioned loans are filled all liabilities towards all members of London club taken in year 1997.

25. LONG-TERM LIABILITIES TO THE GOVERNMENT

The long-term debt to the Government in the amount of HRK 33,734 thousand relates to the obligation arising on the sale of housing units to employees under the Government program, which was discontinued in 1996. According to the law regulating housing sales, 65% of the proceeds from the sale of apartments to employees were payable to the state at such time as the proceeds were collected. According to the law, HEP d.d. has no liability to remit the funds, unless and until they are collected from the employee. Decrease of liabilities in comparison to 2009 year is caused by write off of receivables from banks based on sold apartments paid with old foreign-currency savings as well as liabilities towards State up to 65% of sold apartments also paid with old foreign-currency savings.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

26. DERIVATIVE FINANCIAL INSTRUMENTS

Interest rate swap

The Group has one interest rate swap contract which hedges the Group's exposure to variable interest rate debt. Under the contract, the six-month interest rate payable by the Company is fixed at 5.39%, while the swapped interest rate is equal to the six-month EURIBOR rate, approximately 1.2019% at 31 December 2010 (2009: approximately 1.0075 %).

Contract settlements are payable every six months. The contract matures on 25 October 2012. The notional principal amount of the interest rate swap contract at 31 December 2010 was EUR 10,226 thousand (2009: EUR 15,339 thousand). The fair value of the interest rate swap contract, representing a future obligation, at 31 December 2010 amounted to HRK 2,875 thousand (2009: HRK 6,284 thousand). The related deferred tax asset at 31 December 2010 amounted to HRK 575 thousand (2009: HRK 1,257 thousand).

The non-current and the current portions of the obligation are presented below:

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Long-term portion (Note 29)	672	3,513
Current portion (Note 33)	2,203	2,771
	<u>2,875</u>	<u>6,284</u>

27. LONG-TERM PROVISIONS

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Litigation provision	162,443	145,335
Provision for retirement bonuses	302,157	233,949
Provision for jubilee awards	46,268	53,900
Thermal power plant decommissioning provision	93,121	92,280
Decommission costs of NPPK	-	4,932
Provision for NPPK decommissioning (long-term)	53,838	-
Provision according to damages contract	80,800	28,621
Provision for delivered electricity from wind power plants	22,031	-
Provision for investment in HE Lešće	39,287	-
	<u>799,945</u>	<u>559,017</u>

The thermal power plant decommissioning provision in the amount of HRK 93,121 thousand represents a discounted value of the estimated decommissioning costs of the Group's thermal power plants.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

27. LONG-TERM PROVISIONS (continued)

Movements in the present value of defined benefit obligations in the current period were as follows:

HRK'000	Legal actions	Retirement bonuses	Jubilee awards	Decommissioning - NPPK	Decommissioning of TPPs	Other	Total
At 1 January 2010	145,335	233,949	53,900	4,932	92,280	28,621	559,017
Current portion	-	-	-	-	-	-	-
New provisions made	75,986	85,360	1,402	53,838	5,548	113,495	335,631
Decrease in provisions (amounts paid)	(58,808)	(17,152)	(9,030)	(4,932)	-	-	(89,922)
Decrease in provision on valuation	(70)	-	(4)	-	(4,707)	-	(4,781)
At 31 December 2010	162,443	302,157	46,268	53,838	93,121	142,118	799,945

Provision for legal cases refers to cases where possible outcome has been determined as uncertain or negative, total amount of provision for legal cases is HRK 162,443 thousand. The most important court case for which provision was made is in HEP Proizvodnja d.o.o. for dispute with Zagrebački Holding (provision expense in 2010 amounts to HRK 29,611 thousand and refers to suit for reimbursement of fee for purification of waste water) and Projektni biro Split (expense in 2010 amounts to HRK 10,605 thousand and refers to suit for not conducting contract based on public tender); in HEP Operator prijenosnog sustava d.o.o. (expense in 2010 amounts to HRK 13,445 thousand and refers to suit of private person for reimbursement of fee for expropriated property in State county office in Split.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

27. LONG TERM PROVISIONS (continued)

Movements in the present value of defined benefit obligations in respect of employee benefits during the current period were as follows:

	Retirement benefits	Jubilee awards	Total
	HRK'000	HRK'000	HRK'000
At 1 January 2010	233,949	53,900	287,849
Cost of services	(15,499)	(8,885)	24,384
Interest expenses	18,025	2,717	20,742
Recognized cost in prior period	-	(6,170)	(6,170)
Benefits paid	10,924	2,389	13,313
Actuarial gains/(losses)	54,758	2,317	57,075
At 31 December 2010	302,157	46,268	348,425

The following assumptions were used in preparing the calculations:

- The termination rate is from 0% to 10% percent and is based on the statistical fluctuation rates for the Company in the period from 2005 to 2010.
- The probability of death by age and sex is based on Croatian Mortality Tables 2004 published by the Croatian Statistical Bureau. It is assumed that the population of employees of the Company represents average with respect to mortality and health status.
- We assumed the annual salary will not grow in other years.
- The present value of the obligation was determined using a 6.5% discount rate for HEP d.d. and 6.6% for other Companies within Group.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

28. ISSUED BONDS

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Nominal value of bonds	1,200,000	1,200,000
Repayment	(46,690)	-
Discount value	(1,888)	(2,423)
Current portion of bonds	(93,380)	(46,690)
	<u>1,058,042</u>	<u>1,150,887</u>

Bonds in the amount of HRK 500,000 thousand, issued in 2006, are due in 2013, and bear interest at a fixed rate of 5.00 percent. Bonds in the amount of HRK 700,000, issued at the end of 2007, are repayable in 15 semi-annual instalments, commencing three years from the date of issue, and bear interest at a fixed rate of 6.50 percent. The HEP d.d. bonds are listed on the Zagreb Stock Exchange.

29. OTHER NON-CURRENT LIABILITIES

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Deferred income	4,753,554	4,683,583
Deferred recognition of income – clearing debt	414,938	239,926
Long-term debt under interest rate swap (Note 26)	672	3,513
Other	1,779	-
	<u>5,170,943</u>	<u>4,927,022</u>

Deferred revenue is related to fixed assets contributed by customers and others without charge. The revenue is recognized into income over the same periods as the related assets are amortized, which applies to contracts for connection to the network concluded by 31 December 2009. After 1 January 2010 the fee for connection is recognized as income in the amount of funds received from the customer in the period when the customer is connected to the network or when permanent access to the delivery of the service is given.

Committee for the interpretation of International Financial Reporting Standards (IFRIC) has issued in January 2009 Interpretation of the 18 - Transfer of assets from customers (IFRIC 18), with mandatory application from 01 July 2009.

29. OTHER NON-CURRENT LIABILITIES (continued)

In Republic of Croatia mentioned interpretation has come into force as of 1 January 2010 by decision of Standards of finance interpretation board as of 11 January 2010 (Official Gazette No. 18/2010).

Therefore, the HEP d.d. management made a decision to change accounting policy whereby the interpretation of the Committee for the interpretation of International Financial Reporting Standards 18 "The transfer of assets from the customer" applies from 1 January 2010.

The effect of adoption of IFRIC 18 as of 1 July 2009 on financial statements for year ended 31 December 2009 has not been done.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

30. SHORT-TERM BORROWINGS

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Borrowings from domestic banks and branch offices of foreign banks, denominated in various currencies on the following terms:	282,252	761,320
Interest rates ranging from EURIBOR + (1.50 – 5.90%)	-	-
Interest rates on Ministry of Finance Treasury Bills + (1.00 – 2%)	-	-
Secured by bills of exchange	-	-
Borrowings from domestic companies on the following terms:	2,805	2,805
Secured by bills of exchange	-	-
Current portion of RWE loan	7,436	3,680
	<u>292,493</u>	<u>767,805</u>

During 2010, the Group used short-term loans from domestic banks for working capital purposes and for the settlement of trade payables. Due to improved liquidity situation during the year, the Group has reduced short term debt by 75% over the previous year.

31. LIABILITIES FOR TAXES AND CONTRIBUTIONS

	31 December 2010	31 December 2009
	HRK '000	HRK '000
Liabilities for income tax	357,228	116,563
Utility and other fees	25,596	28,573
Contributions on salaries	23,953	24,217
Liabilities for custom	20,153	5
Contributions and taxes for benefits in kind	14,880	-
Other	3,175	1,722
	<u>444,985</u>	<u>171,080</u>

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

32. LIABILITIES TO EMPLOYEES

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Net salaries	81,133	77,334
Contributions	41,953	46,614
Other	11,140	19,184
	<u>134,226</u>	<u>143,132</u>

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

33. OTHER PAYABLES

	31 December 2010	31 December 2009
	HRK'000	HRK'000
Liabilities for renewable sources	16,446	228,351
Decommissioning NPPK accrued expenses	5,023	41,645
Deferred income and received advances	117,752	7,117
Accrued expenses for unused vacation days	64,477	-
Accrued expenses	9,459	5,464
Current portion of the liability under interest rate swap (Note 26)	2,203	2,771
Other payables	43,968	47,408
	<u>259,328</u>	<u>332,756</u>

34. RELATED PARTY TRANSACTIONS

The Group has a 50% ownership in the capital of the NPPK.

The produced electric energy at NPPK is delivered to HEP d.d. at 50% of total produced quantities at a price which is determined in accordance with the total production costs of NPPK.

Receivables and payables, and income and expenditure arisen from related party transactions are presented in the table below:

	31 December 2010	31 December 2009
	HRK'000	HRK'000
NE Krško d.o.o.		
Liabilities for purchased electricity	61,090	41,451
Cost of purchased electricity	594,612	557,575

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

34. RELATED PARTY TRANSACTIONS (continued)

HRK'000	Sales revenue		Purchases	
	2010	2009	2010	2009
Enterprises controlled by the Government				
Hrvatske Željeznice	123,627	92,624	16,260	15,746
INA-Industrija nafte	135,772	155,097	1,480,394	1,660,633
Prirodni plin	134	171	427,615	152,322
Plinacro	1,102	974	38,508	12
Hrvatske telekomunikacije	77,854	75,011	29,382	19,337
Croatia osiguranje	6,181	4,754	15,842	15,558
Hrvatska pošta	21,115	17,480	51,251	48,853
Hrvatske šume	6,572	5,959	13,784	14,364
Jadrolinija	1,107	1,202	603	398
Narodne novine	2,081	2,081	5,667	4,963
Croatian Radio & Television	12,763	13,898	1,124	1,060
Plovput	543	559	163	210
Croatia Airlines	807	772	110	63
Petrokemija Kutina	8,311	9,965	133	6,834
Ministry of Foreign Affairs	621	598	-	-
Ministry of Defence	31,172	34,743	-	-
Ministry of Interior	25,621	24,100	-	-
Elementary and secondary schools	78,697	80,008	-	-
Judicial institutions	10,563	11,004	-	-
Colleges and universities	29,715	32,138	4,869	15,785
Legislative, executive and other bodies of the Republic of Croatia	48,470	63,850	7,648	12,115
Health institutions and organisations	92,427	112,586	4,027	4,906
Other users	109,474	94,142	143,354	146,203
TOTAL	824,729	833,716	2,240,734	2,119,362

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

34. RELATED PARTY TRANSACTIONS (continued)

HRK'000	Receivables		Payables	
	31 December 2010	31 December 2009	31 December 2010	31 December 2009
Enterprises controlled by the Government				
Hrvatske Željeznice	34,957	20,229	3,238	5,091
INA-Industrija nafte	8,483	15,559	210,541	164,723
Prirodni Plin	7	28	76,652	53,944
Plinacro	32	15	9,631	-
Hrvatske telekomunikacije	8,761	8,407	8,879	6,485
Croatia osiguranje	668	469	-	-
Hrvatska pošta	3,156	3,301	4,637	7,966
Hrvatske šume	2,017	1,287	925	235
Jadrolinija	242	195	561	487
Narodne novine	246	259	1,397	1,641
Croatian Radio & Television	2,233	1,636	143	275
Plovput	68	64	49	49
Croatia Airlines	150	176	64	113
Petrokemija Kutina	668	797	-	-
Ministry of Defence	4,531	11,455	-	-
Ministry of Interior	7,442	6,274	-	-
Elementary and secondary schools	15,135	13,477	-	-
Judicial institutions	2,983	2,148	-	-
Colleges and universities	4,516	4,411	-	-
Legislative, executive and other bodies of the Republic of Croatia	7,038	7,046	-	-
Health institutions and organizations	34,970	25,895	-	-
Other users	16,245	17,060	9,888	12,865
TOTAL	154,548	140,188	326,605	253,874

Under the Croatian energy laws, the Company is an eligible gas buyer, for whom gas prices differ from the market ones.

35. CONTINGENT LIABILITIES AND COMMITMENTS

Legal actions

In 2010, the Group established a provision for legal actions estimated to be ruled against HEP d.d..

The Group has long-term financial investments in the territory of Bosnia and Herzegovina, and Serbia which in 1994 had a historical cost of HRK 1,243,970 thousand. At the time of the transformation of the Company into a joint stock company in 1994, this amount was excluded from the net asset value.

Operating commitments

As at 31 December 2010, as part of its investing activities, the Group has concluded contracts under which the construction of a number of significant facilities and other investments has commenced but has not been completed. The unrealised contract value for most significant projects amounts to approximately HRK 1,986,175 thousands (2009: HRK 2,163,949 thousand).

Most significant investments refers to investments in HEP Proizvodnja d.o.o., HEP Operator prijenosnog sustava d.o.o. and HEP Operator Distribucijskog sustava d.o.o

Environmental matters

The principal activities of the Group are generation, transmission and distribution of electricity, and the control of the electric power systems.

In addition to these main activities, the HEP Group deals with the production and distribution of thermal power through the district heating systems in Zagreb in Osijek, and the distribution of gas in Osijek and Đakovo. These principal business activities can have inherent effects on the environment in terms of emissions into soil, water and air. The environmental effects of the Company's and Group's activities are monitored by local management and environmental authorities.

Croatia requested membership to the European Union. As part of the succession process environmental regulations similar to those at other EU countries might be introduced in Croatia. Such environmental regulations might have an impact on environmental liabilities for the Group.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

36. SUBSIDIARIES

As at 31 December 2010, the Group had the following subsidiaries:

Subsidiary	Country	Interest in (%)	Main activity
HEP-Proizvodnja d.o.o.	Croatia	100	Electricity generation and heating
HEP-Operator prijenosnog sustava d.o.o.	Croatia	100	Electricity transmission
HEP-Operator distribucijskog sustava d.o.o.	Croatia	100	Electricity distribution
HEP Opskrba d.o.o.	Croatia	100	Electricity supply
HEP-Toplinarstvo d.o.o.	Croatia	100	Thermal power generation and distribution
HEP-Trgovina d.o.o.	Croatia	100	Electrical energy trading and optimization of power plants production
HEP-Plin d.o.o.	Croatia	100	Gas distribution
TE Plomin d.o.o.	Croatia	50	Electricity generation
Agencija za posebni otpad d.o.o.	Croatia	100	Special waste management
HEP ESCO d.o.o.	Croatia	100	Financing of energy efficiency projects
Plomin Holding d.o.o.	Croatia	100	Development of infrastructure in area around Plomin
Buško Blato d.o.o.	BiH	100	Maintenance of hydro power plants
HEP-Odmor i rekreacija d.o.o.	Croatia	100	Accommodation and recreation services
HEP-NOC Velika	Croatia	100	Accommodation and training
HEP-Obnovljivi izvori energije d.o.o.	Croatia	100	Electricity generation

The majority of these subsidiaries were created for the purpose of reorganization and re-structuring the core business activities driven by the new energy legislation, which came into effect as of 1 January 2002, as indicated in Note 1.

37. FINANCIAL INSTRUMENTS**Capital risk management**

The Group manages its capital to ensure that it will be able to continue as a going concern while maximising the return to stakeholders through the optimisation of the debt and equity balance.

The capital structure of the Company consists of debt, which includes the borrowings and issued bonds disclosed in Note 24 and 28, cash and cash equivalents and equity attributable to equity holders of the parent, comprising issued capital, legal and other reserves and retained earnings.

Gearing ratio

The Group's risk management committee reviews the capital structure on a semi-annual basis. As part of this review, the committee considers the cost of capital and the risks associated with each class of sources of funding. The gearing ratio at the yearend can be presented as follows:

<i>(HRK'000)</i>	31 December 2010	31 December 2009
Debt	5,512,390	6,026,596
Cash and cash equivalents	<u>(762,157)</u>	<u>(143,834)</u>
Net debt	4,750,233	5,882,762
Equity	<u>19,679,852</u>	<u>18,248,114</u>
Net debt to equity ratio	<u>24%</u>	<u>32%</u>

Significant accounting policies

Details of the significant accounting policies and methods adopted, including the criteria for recognition, the basis of measurement and the basis on which income and expenses are recognised, in respect of each class of financial asset, financial liability and equity instrument are disclosed in Note 2 to the financial statements.

Categories of financial instruments

<i>(HRK'000)</i>	31 December 2010	31 December 2009
Financial assets		
Loans and receivables (including cash and cash equivalents)	3,022,637	2,267,846
Other non-current assets	111,029	270,103
Financial liabilities		
Non-current liabilities	5,672,893	5,318,504
Current liabilities	2,713,686	3,658,396

37. FINANCIAL INSTRUMENTS (continued)**Financial risk management objectives**

The Group's Treasury function provides services to the business, co-ordinates access to domestic and international financial markets, monitors and manages the financial risks relating to the operations of the Group through internal risk reports which analyse exposures by degree and magnitude of risks. These risks include market risk (including currency risk, fair value interest rate risk and price risk), credit risk, liquidity risk and cash flow interest rate risk.

Market risk

The Group's activities expose it primarily to the financial risks of changes in foreign currency exchange rates and interest rates (see below). Market risk exposures are supplemented by sensitivity analysis. There has been no change to the Group's exposure to market risks or the manner in which it manages and measures the risk.

Foreign currency risk management

The Group undertakes certain transactions denominated in foreign currencies. Hence, exposures to exchange rate fluctuations arise. Exchange rate exposures are managed within approved policy parameters utilising forward foreign exchange contracts.

The carrying amounts of the Group's foreign currency denominated monetary assets and monetary liabilities at the reporting date are as follows:

	Assets		Liabilities	
	31 December 2010 <i>(in '000)</i>	31 December 2009 <i>(in '000)</i>	31 December 2010 <i>(in '000)</i>	31 December 2009 <i>(in '000)</i>
European Union (EUR)	88,390	3,866	573,176	647,683
USD	34	198	75,315	82,591

37. FINANCIAL INSTRUMENTS (continued)***Foreign currency sensitivity analysis***

The Group is mainly exposed to the changes of euro (EUR) and US dollar (USD). The following table details the Group's sensitivity to a 10% increase and decrease in the HRK against EUR and USD. 10% is the sensitivity rate used when reporting foreign currency risk internally to key management personnel and represents Management's assessment of the reasonably possible change in foreign exchange rates. The sensitivity analysis includes only outstanding foreign currency denominated receivables and liabilities and adjusts their translation at the period end for a 10% change in foreign currency rates. The sensitivity analysis includes external loans where the denomination of the loan is in a currency other than the currency of the lender or the borrower. A positive / negative number below indicates an increase in profit and other equity where HRK strengthens 10% against the relevant currency. For a 10% weakening of the HRK against the relevant currency, there would be an equal effect, but the balance would be negative.

	2010	2009
	HRK'000	HRK'000
EUR change impact		
Profit or loss	350,872	470,385
USD change impact		
Profit or loss	38,853	44,809

37. FINANCIAL INSTRUMENTS (continued)

Interest rate risk management

The Group is exposed to interest rate risk as it borrows funds at floating interest rates.

The Group's exposures to interest rates on financial assets and financial liabilities are shown in section of this note, the liquidity risk management. The Group manages this risk by maintaining an appropriate mix between fixed and floating rate borrowings, by the use of interest rate swap contracts.

Interest rate sensitivity analysis

The sensitivity analysis has been determined based on the interest rate exposure of the Group to financial instruments at the date of the statement of financial position.. For floating rates, the analysis is prepared assuming the amount of liability outstanding at the reporting date was outstanding for the whole year. A 50 basis point increase or decrease is used when reporting interest rate risk internally to key management personnel and represents Management's assessment of the reasonably possible change in interest rates.

If interest rates had been 50 basis points higher/lower and all other variables were held constant, the Group's:

- Profit for the year ended 31 December 2010 would decrease/increase by HRK 21,153 thousand (2009: HRK 22,031 thousand), based on exposure to interest rate risk. This is mainly attributable to the Group's exposure to interest rates on its variable rate borrowings, which accounted for 77% in 2010 (2009: 73%); and
- The Group's sensitivity to interest rates has decreased during the current period mainly due to the reduction in variable rate of debt instruments.

Credit risk management

Credit risk refers to the risk that counterparty will default on its contractual obligations resulting in financial loss to the Group. The Group is the sole provider of electric energy in the Republic of Croatia. As such, it has a public responsibility to provide services to all users, and locations within the country, irrespective of credit risk associated with particular customers. Trade receivables, net, consist of a large number of customers, spread across diverse industries and geographical areas.

The Group does not have any significant credit risk exposure to any single counterparty or any group of counterparties having similar characteristics. The Group defines counterparties as having similar characteristics if they are related entities. Credit risk with respect to trade receivables is primarily related to domestic corporate receivables, specifically where services are provided to economic concerns, which are in a difficult financial position. Overdue receivables from households are limited due to Group's ability to disconnect such customers from the power supply network.

Except as detailed in the following table, the carrying amount of financial assets recorded in the financial statements, which is net of impairment losses, represents the Group's maximum exposure to credit risk without taking account of the value of any collateral obtained.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

37. FINANCIAL INSTRUMENTS (continued)

Liquidity risk management

Ultimate responsibility for liquidity risk management rests with the Management Board, which has built an appropriate liquidity risk management framework for the management of the Group's short, medium and long-term funding and liquidity management requirements. The Company manages liquidity risk by maintaining adequate reserves, banking facilities and other sources of financing, by continuously monitoring forecast and actual cash flows and matching the maturity profiles of financial assets and liabilities.

Liquidity and interest rate risk tables

The following table details the remaining period to contractual maturity for the Group's non-derivative financial assets. The tables below have been drawn up based on the undiscounted cash flows of the financial assets including interest that will be earned on those assets except where the Group anticipates that the cash flow will occur in a different period.

Maturity of non-derivative financial assets

	Weighted average effective interest rate %	Less than 1 month (HRK'000)	1 - 3 months (HRK'000)	3 -12 months (HRK'000)	1 - 5 years (HRK'000)	Over 5 years (HRK'000)	Total (HRK'000)
2010							
Non-interest bearing		1,096,670	1,424,595	194,103	396,981	21,317	3,133,666
Variable interest rate instruments	5.00%	23	46	196	105	-	370
Total		1,096,693	1,424,641	194,299	397,086	21,317	3,134,036
2009							
Non-interest bearing		1,179,933	676,596	179,562	484,635	16,569	2,537,295
Variable interest rate instruments	6.00%	24	47	207	376	-	654
Total		1,179,957	676,643	179,769	485,011	16,569	2,537,949

The following tables detail the Group's remaining contractual maturity for its non-derivative financial liabilities.

The tables have been drawn up based on the undiscounted cash flows of financial liabilities based on the earliest date on which the Group can be required to pay.

37. FINANCIAL INSTRUMENTS (continued)**Liquidity and interest rate risk tables (continued)****Maturity of non-derivative financial liabilities**

	Weighted average effective interest rate %	Less than 1 month (HRK'000)	1 - 3 months (HRK'000)	3 -12 months (HRK'000)	1 - 5 years (HRK'000)	Over 5 years (HRK'000)	Total (HRK'000)
2010							
Non-interest bearing		784,785	792,584	839,403	441,593	15,824	2,874,189
Variable interest rate instruments	3.57%	43,200	571,673	982,759	2,539,715	451,013	4,588,360
Fixed interest rate instruments	5.93%	8,766	-	186,200	1,111,980	204,721	1,511,667
Total		836,751	1,364,257	2,008,362	4,093,288	671,558	8,974,216
2009							
Non-interest bearing	-	983,852	1,290,073	641,161	14,817	20,402	2,950,305
Variable interest rate instruments	3.94%	29,215	216,748	858,979	3,682,705	688,477	5,476,124
Fixed interest rate instruments	5.96%	3,278	255,811	130,276	1,185,654	452,499	2,027,518
Total		1,016,345	1,762,632	1,630,416	4,883,176	1,161,378	10,453,947

The Group has access to financing facilities, the total unused amount of which is HRK 665,014 thousand at the reporting date. The Group expects to meet its other obligations from operating cash flows and proceeds of maturing financial assets.

Maturity of derivative financial liabilities

The Group has an interest rate swap, which it uses to hedge its exposure to variable rate debt. Based on the underlying agreement, the six-month interest rate payable by the Company is fixed at 5.39 %, whereas the swap rate is equal to six-month EURIBOR, or approximated at 1.2019 % at 31 December 2010 (2009: 1.0075 %), as disclosed in detail in Note 26.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

37. FINANCIAL INSTRUMENTS (continued)

	Weighted average effective interest rate	Less than 1 month	1 - 3 months	3 -12 months	1 - 5 years	Over 5 years	Total
	%	(HRK'00)	(HRK'000)	(HRK'000)	(HRK'000)	(HRK'00)	(HRK'000)
31 December 2010							
Variable interest rate instruments	1.2019%	-	-	1,108	476	-	1,584
Fixed interest rate instruments	5.39%	-	-	(4,969)	(2,136)	-	(7,105)
Total		-	-	(3,861)	(1,660)	-	(5,521)
31 December 2009							
Variable interest rate instruments	1.0075%	-	-	1,444	1,314	-	2,758
Fixed interest rate instruments	5.39%	-	-	(7,726)	(7,029)	-	(14,755)
Total		-	-	(6,282)	(5,715)	-	(11,997)

Fair value of financial instruments

Valuation methods or assumptions in determining fair value

The fair values of financial assets and financial liabilities are determined as follows:

- The fair value of financial assets and financial liabilities with standard terms and conditions and traded on active liquid markets is determined with reference to quoted market prices.
- the fair value of other financial assets and financial liabilities (excluding derivative instruments) is determined in accordance with generally accepted pricing models based on discounted cash flow analysis using prices from observable current market transactions and dealer quotes for similar instruments.
- fair value of derivative instruments is calculated using the listed price. Where such prices are not available, the analysis uses discounted cash flows using the current yield curve for the period of the instruments under optional derivatives, while the optional derivative used models for pricing options. Forward currency contracts are valued using quoted forward exchange rates and yield curves derived from quoted interest rates for contracts with similar maturity. Interest rate swaps are valued at the present value of estimated future cash flows and discounted based on the current yield curve derived from quoted interest rates.

Notes to the consolidated financial statements of the HEP Group (continued)

For the year ended 31 December 2010

37. FINANCIAL INSTRUMENTS (continued)

Fair value measurements recognized in the statement of financial position

The table below analyzes the financial instruments remeasured subsequently at fair value, classified into three groups depending on the availability of indicators of fair value:

Level 1 observable indicators - indicators of fair value derived from (unadjusted) prices quoted in active markets for identical assets and liabilities are identical

Level 2 observable indicators - indicators of fair value derived from data other than quoted prices from Level 1 for observable assets or liabilities (i.e. their prices) or indirectly (derived from the price), and

Level 3 indicators - indicators derived from valuation techniques using as input data on the assets or liabilities that are not based on available market data (unobservable input).

The indicators of fair value recognized in the balance

	1st level	2nd level	3rd level	Total
	HRK'000	HRK'000	HRK'000	HRK'000
2010				
Assets available for sale	162,380	-	-	162,380
Interest swap liability (current and non current portion)	-	2,875	-	2,875
2009				
Assets available for sale	152,797	-	-	152,797
Interest swap liability (current and non current portion)	-	6,284	-	6,284

38. APPROVAL OF THE FINANCIAL STATEMENTS

These financial statements were approved by the Board and authorised for issue on 25 May 2011

Signed on behalf of the Management Board on 25 May 2011:

Leo Begović

President of the Board

Miljenko Pavlaković

Member of the Board