

Annual consolidated financial statements for the year 2015

MANAGEMENT BOARD'S REPORT ABOUT FINANCIAL POSITION AND ANALYSIS OF BUSINESS RESULTS – REPORT OF THE MANAGEMENT

In 2015 HEP Group achieved very good business results, which improved the financial position of the Group. According to revised financial reports, in 2015 consolidated net profit was HRK 1,940.1mn while new issuance of corporate bonds prolonged the maturity of the funding sources which eliminated the risk of refinancing USD 500mn of debt due in 2017.

Economic growth, a colder winter and extremely high temperatures during summer influenced the increase of electricity consumption in Croatia.

Moreover, colder winter led to an increase in heat energy and gas sale.

Gas and coal prices continued to decrease in 2015, as well as the price of electricity on referential power exchanges in the region. However, since realized generation in hydro power plants amounted to 5.7 TWh in 2015, which is 2.7 TWh (32.1%) less than record generation of 8.4 TWh in 2014, electricity procurement on the market increased significantly, which affected the growth of operating expenses.

In the second half of 2015, the price of electricity for the household customers as part of universal service was reduced. Additional discount of HRK 0.03 per kWh to its household customers was approved by HEP in last quarter, to avoid price increase after adoption of the Regulation on criteria for gaining the status of vulnerable customers of energy from network system (OG 95/2015), which provided a solidary fee for compensating energy costs of vulnerable customers.

Operating income of HRK 14,569.5mn which is an increase of HRK 970.3mn (7.1%) in comparison to the previous year. Revenue from electricity sales decreased by HRK 37.9mn (0.4%), as a result of the decrease in revenue from sales in foreign markets due to decreased exports of electricity from HEP's power plants, lower generation from hydro power plants, whereas the income from sale to domestic customers increased when compared to the year before.

Revenue from heat sales increased by HRK 10.4mn (1.6%), as a result of 3.7% higher consumption due to colder winter at the beginning of 2015.

Revenue from retail gas sales increased by HRK 15.0mn (4.0%), which is also a result of colder winter and also the fact that HEP Group extended gas supply outside the distribution network in eastern Slavonia, which have gained new customers.

Revenue from gas sales on the wholesale market increased by HRK 608.8mn (88.3%) compared to 2014, as this business activity started on 1st of April 2014.

All other operating income increased by HRK 374.0mn (29.0%), primarily because of HRK 328.9mn claim against the Republic of Slovenia for undelivered electricity from nuclear power plant Krško in the period between 1 July 2002 and 19 April 2003.

Operating expenses of HRK 11,573.7mn present an increase of HRK 1,175.0mn (11.3%). In comparison with 2014 electricity import increased due to lower generation in hydro power plants, increased trading outside Croatian energy system and due to increased electricity sale to domestic customers, which led to HRK 743.1mn (61.9%) higher expenses of electricity procurement.

Electricity and heat generation in thermal power plants also increased, so more fuel oil and natural gas was used. Therefore, fuel expenses increased by HRK 21.9mn (1.2%).

Other operating expenses decreased by HRK 195.5mn (6.7%) due to lower prices of gas for supplying customers and decrease in provisions and value adjustments.

The total of HRK 2,528.1mn were invested, mostly to replacement, reconstructions, revitalization and rehabilitation of existing energy facilities (HRK 909.7mn), the construction and the development of new energy facilities (HRK 428.9mn) and for connecting customers (HRK 313.9mn). All investments were financed from own funds without need for additional long-term debt.

Group's net debt as at 31 December 2015 was HRK 3,146.8mn and it decreased by 19.2% in comparison with the beginning of the year. The share of long-term debt in the total debt is 91.5%, and of short-term debt is 8.5%. Liabilities for issued bonds increased because of new issuance of bonds, which were mostly used to refinance bonds issued in 2012. This issuance extended the average maturity of funding sources with the decrease of average weighted cost of financing. This transaction resulted in a significant positive net financial effect, due to lower cost of financing, repurchase of 2012 bonds, a positive effect of cancelling existing lines of protection against currency risk and it additionally strengthened the financial position and liquidity of HEP Group.

Since rating agency Standard and Poor's in 2015 changed the outlook of credit rating for the Republic of Croatia from stable into negative, because of the methodology for state-owned companies is applied when rating HEP, in the report published on 22 July 2015, it consequently lowered the outlook of HEP's rating from stable into negative. Rating agency Moody's revised in 2015 the rating and confirmed existing rating (Ba2) with a stable outlook. Both agencies confirmed its rating for USD 550mn bond issuance in October.

During 2015 the process of restructuring HEP Group's companies was completed (except for the Hrvatski operator prijenosnog sustava ltd. and HEP-Operator distribucijskog sustava ltd.), which increased the effectiveness of business and conducted the optimization of business processes. The process of restructuring HEP-Operator distribucijskog sustava ltd. started, as part of which the process of unbundling supply activities was initiated in line with legal regulations.