

Annual consolidated financial statements for the year 2016

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

In 2016 HEP Group (Hrvatska elektroprivreda d.d. with its affiliated companies: hereinafter HEP) completely fulfilled its mission of good, safe and reliable supply of customers and it has achieved an extremely good result the third year in a row. According to revised financial reports, in 2016 consolidated net profit was HRK 2,045.0mn.

The year 2016 marked the increase in the generation of hydro power plants and thermal power plants (along with the decrease in gas and coal prices) as well as the increase of electricity procurement on the market. HEP increased the sale of electricity in 2016 on the territory of the Republic of Croatia, but the income was lowered. The revenue from electricity sale was affected by the lowering of tariff items for customers within universal service as of 1 July 2015, by the lowering of tariff items for customers within guaranteed supply as of 1 January 2016 and 1 July 2016, as well as by the lowering of the average price for the customers of HEP Opskrba d.o.o. due to the adjustment to the conditions of the competition. Furthermore, due to the application of the Ministry of Economy Regulation on the criteria for gaining the status of vulnerable customers of energy from network system (OG 95/2015) and the HEP's General Shareholders' Assembly Decision, according to which the price of electricity for household customers remains the same so the amount of solidarity surcharge lowered the revenue from electricity sale to customers. The revenue from electricity sale outside the Republic of Croatia increased significantly in comparison to 2015 due to higher export of electricity surpluses generated in HEP's power plants and greater supply of customers in the region.

By conducting a series of activities aimed at improving customer relations, constant offer adjustment to market requirements and marketing campaigns for strengthening HEP's brand, the electricity market share of domestic customers was stabilized. Additionally HEP strengthened its market leader position in electricity supply by making a step forward onto regional markets (Slovenia, Bosnia and Herzegovina and Serbia).

Operating income amount to HRK 14,400.4mn, which is a decrease by HRK 169.1mn (1.2%) in comparison to the year before. The revenue from electricity sale increased by HRK 294.0mn (2.8%), which is a result of an increase in foreign market revenue by HRK 363.9mn, an increase in revenue from HEP's producers in the incentive system of generation from renewable energy sources by HRK 125.1mn as well as the commercial revenue increase in the Republic of Croatia by HRK 36.1mn, while the domestic market revenue decreased by HRK 231.0 million. The revenue from thermal power sales increased by HRK 17.2mn (2.5%) due to a higher average price and the consumption increase of 0.6%. The revenue from the sale of gas to customers decreased by HRK 44.6mn (11.5%) as a result of a lower sale price, whereas the sale increased by 9.5%. The revenue from the sale of gas on

wholesale market decreased by HRK 195.6mn (15.1%), when compared to 2015 due to the lower sale price. All other operating income was lowered by HRK 240.1mn (14.4%) in comparison to 2015, when revenues from the 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 was realized. The income from grid connection services and the income from abolishing provisions increased as well.

Operating expenses in 2016 amount at HRK 11,677.2mn, which is an increase of HRK 103.5mn (0.9%). When compared to 2015, electricity import increased due to higher sale on the wholesale market, supply of customers in the region and the increase of electricity sale to domestic customers, which increased the expenses of electricity procurement by HRK 205.2mn (10.6%). Fuel costs decreased by HRK 251.0mn (13.9%) as a result of lower gas prices, lower coal prices and ceasing of fuel oil usage. The costs of gas sold on the wholesale market decreased by HRK 105.6mn (7.8%). All other operating expenses increased by HRK 319.1mn (11.7%) primarily due to provisions for severance payments based on the termination of employment amounting to HRK 343.0mn for the planned restructuring of HEP Operator distribucijskog sustava d.o.o. (HEP Distribution System Operator d.o.o.) in 2017.

The total of HRK 2,589.1mn were invested, mostly into exchanges, reconstruction, revitalization and renovation of existing energy facilities (HRK 784.7mn), construction and the preparation of construction of new energy facilities (HRK 444.1mn) as well as into connecting customers (HRK 409.0mn).

All investments were financed from own funds without need for additional long-term debt. HEP's net debt as at 31 December 2016 was HRK 2,250.5mn and it decreased by 28.5% in comparison with the beginning of the year due to repayments of loans and issued bonds as well as the increase of the cash position and cash equivalents. The share of long-term debt in the total debt is 81.1%, and of short-term debt is 18.9%.

Active and deliberately liquidity management was confirmed by Standard & Poor's rating agency, which upgraded HEP's stand-alone credit rating from b+ onto bb, also upgrading HEP's overall corporate credit rating from BB- onto BB. So the overall corporate credit rating reached Croatia's sovereign credit rating level. According to the Agency, HEP's credit rating cannot exceed the sovereign credit rating. The rating upgrade is a direct result of active corporate management of HEP's financial position and its overall business activities. This upgrade represents HEP as a stable company with a strategic investment plan as well as the opportunity to grow and expand its business in a very challenging period for energy sector in the whole Europe. Furthermore, since the outlook upgrade on the sovereign credit rating of the Republic of Croatia in December 2016, the Agency confirmed HEP's long-term credit rating (BB) and increased the credit rating outlook from negative to stable.

During 2016, HEP's management, in an extremely demanding and changing environment, focused its operations towards achieving a flexible energy portfolio, optimizing and improving business processes, sustainable marketability and active stakeholder engagement. With an aim of maintaining the leading stake in the Croatian electricity market, HEP has worked intensively in 2016 to further improve its services and to develop and offer innovative products tailored to customers' requirements. It also continued with conducting a series of other activities in line with the norms of sustainable development and socially responsible business.

At the end of February 2016 Hrvatski operator prijenosnog sustava d.o.o. (Croatian Transmission System Operator d.o.o.) successfully completed the procedure of gaining the certificate of the independent electricity transmission operator. The program of restructuring HEP-Operator distribucijskog sustava d.o.o. (HEP-Distribution System Operator d.o.o.) was also developed in 2016, with an aim to improve business strategy, organization and business model as well as business processes, and its implementation is planned for 2017. At the beginning of November, supply business activity was separated from HEP Operator distribucijskog sustava d.o.o., resulting with the establishment of HEP ELEKTRA d.o.o., by which the legal obligation of separating network and supply business activities was fulfilled.

At the end of 2016 HEP had 11,832 employees (including Croatian Transmission System Operator), which is 103 employees less than in 2015. A new Collective Agreement was signed in 2016 and all affiliated companies of HEP Group shall apply it in the period between 1 July 2016 and 31 December 2017.

Stated successful and proactive business, together with HEP's respectable results achieved in 2016 are a solid foundation of HEP's development as a modern and effective company, which can be compared to related European companies and will be ready to deal with future challenges.