

Annual consolidated financial statements for the year 2017**MANAGEMENT BOARD'S REPORT ON FINANCIAL POSITION AND ANALYSIS OF BUSINESS RESULTS**

HEP Group (Hrvatska elektroprivreda d.d. with its subsidiaries: hereinafter HEP) in 2017 fulfilled its mission of safe, quality and reliable electricity supply to customers and achieved an exceptionally good result. According to the revised financial reports, the consolidated net profit of HRK 1,300.3mn was earned in 2017.

Economic growth, colder winter at the beginning of the year and high temperatures during summer resulted in a 4.5% increase of domestic electricity consumption compared to 2016, with HEP Opskrba d.o.o. (HEP Supply) and HEP Elektra d.o.o. increasing their electricity sale by 4.3%. In 2017 HEP retained its stable market share in electricity supply of domestic customers. Moreover, HEP increased number of customers and sale of electricity in Slovenia.

As a result of colder weather at the beginning of the year, the sale of heat and gas increased while higher temperatures during the heating season led to decreased consumption. The increase in gas sale was due to the expansion in gas supply outside HEP's gas distribution network in the region of East Slavonia.

Nuclear power plant Krško generated 9.9% more electricity (2,984 GWh) because in 2017 there was no power plant replacement, which reduced the cost of the procurement. Generation in thermal power plants increased by 402 GWh (11.1%), with generation growth in gas-fired power plants and lower generation in coal-fired power plants. The purchase of electricity on the market, including the purchase of renewable sources and cogeneration, was higher by 1.3 TWh (20.3%). The 2017 was characterized by unfavourable hydrology. Hydropower plants generated 5.0 TWh which was by 1.1 TWh (18.5%) less compared to 2016.

Operating revenue of HRK 14,969.3mn increased by HRK 568.9mn (4.0%) compared to 2016.

Income from the sale of electricity increased by HRK 662.2mn (6.1%) to HRK 11,493.7mn. Said income generated domestically was the result of increased consumption as well as increased sale by HEP's producers within the system of renewable energy sources and High-Efficiency Cogeneration Fee. Income from the sale of electricity abroad also increased due to a higher average price of sold electricity on the wholesale market and increased regional customer supply.

Income from the sale of heat of HRK 683.3mn decreased by HRK 16.3mn (2.3%) due to 1.3% lower consumption. Income from the gas wholesale of HRK 963.9mn decreased by HRK 138.8mn (12.6%) compared to 2016 due to a lower sale volume as well as the change in the selling price. Income from the sale of gas to end customers of HRK 316.6mn decreased by HRK 25.2mn (7.4%) as a result of the lower selling price, while the volume of sale increased by 7.0%.

Operating expenses of HRK 12,674.5mn were recorded in 2017, an increase by HRK 997.3mn (8.5%).

Due to increased electricity generation by thermal power plants and more frequent operation of gas-fired power plants at lower gas purchase price and less frequent coal-fired power plants at higher coal prices, the cost of energy fuel increased by HRK 355.1mn (22.9%) to HRK 1,903.1mn compared to the year before.

In light of increased customer supply domestically and in the region as well as increased wholesale volume and the rise of the purchase price as a consequence of increased wholesale market prices, the cost of electricity procurement rose by HRK 638.2mn (29.7%) to HRK 2,786.4mn.

At the same time, the cost of gas procurement for wholesale activities of HRK 1,130.1mn decreased by HRK 116.3mn (9.3%) due to less procured gas volumes.

As of 31 December 2017, HEP's net debt of HRK 2,253.1mn retained its early year level. Loan and bond repayments were made in the amount of HRK 1.0bn.

Pursuant to the decision adopted by the General Assembly, HEP paid into the State Budget dividend in the amount of HRK 794.3mn for the profit earned from business operations in 2016, which was by HRK 187.3mn more than the dividend paid in 2016.

The investments of HRK 2.4bn were made in 2017, all of which were funded by own sources without any need for additional long-term debt. Major investments were made in replacements, reconstructions, revitalizations and the renovation of the existing power facilities (HRK 930.3mn), customer connections (HRK 373.3mn), and the construction and construction preparation of new power facilities (HRK 370.9mn).

Favourable liquidity management was acknowledged by Standard & Poor's, the agency which in 2017 confirmed the upgrade of HEP's stand-alone credit rating of bb as well as HEP's all-in credit rating of BB. In March 2017, Moody's confirmed HEP's long-term credit rating (Ba2) as well as change the rating outlook from negative to stable.

The restructuring process continued in 2017. It has been focused on adjusting the business system to new, increasing requirements which have been facing distribution system operators in Europe, including Croatia, and the improvement of the business processes. The full unbundling of the public service of electricity supply from electricity distribution was conducted as required by law in the form of HEP ELEKTRA d.o.o. Pursuant to the Restructuring Programme implementation, the new organization of the headquarter of HEP- Operator distribucijskog sustava d.o.o. (HEP-Distribution System Operator or HEP-DSO) was set up as of 1 April 2017, while the new organization of distribution areas has been in place since 1 November 2017. As a result of said restructuring processes, 1,284 employees of HEP-DSO will leave until end of May 2018.

At the end of 2017, HEP employed 11,894 workers, 62 more than in the same period last year. The Collective Agreement was signed in late 2017 for all HEP Group companies. It is in force from 1 January 2018 until 31 December 2019.