

No.13293/May 16, 2016

NOTE
on the amendment of the calculation method of the performance indicators
included in the Directors Agreement

Whereas:

✍ the provisions of Art.4 of the Directors Agreement:

“...the Director will execute all acts required ... in order to achieve the performance objectives and criteria established in Annex 1 to this document, and/or as annually amended, as the case may be, together with the other members of the Board of Directors, within 30 days from the approval/rectification of the income and expenditures budget”;

✍ the provisions of Art.9 of the Directors Agreement:

“The Director undertakes, together with the other Directors, to fulfil the governing plan and GMS resolutions, in order to achieve the objectives and performance criteria established in Annex 1 to this Director Agreement. Performance criteria and objectives are applicable during the entire assignment of the Director, and the values of the performance indicators will be updated annually in accordance with the provisions of the income and expenditure budget”;

✍ “SNGN “ROMGAZ” SA Governing Plan for 2013-2017”, as approved by the General Meeting of Shareholders in Resolution no.16/September 25, 2013, stating that:

↳ *“The performance indicators provided in this plan, resulting from the strategic objectives and the plan of measures to be achieved for fulfilling such objectives, shall be reviewed in order to be approved by the General Meeting of Shareholders, if it is found that for reasons beyond the director’s control, for external factors (the decline of the natural gas market and the electricity market, changes in the legal and regulatory frame etc.) or as a result of restating the financial statements in compliance with the International Financial Reporting Standards (IFRS) the objectives and the performance indicators cannot be fulfilled”*

- summary of the Governing Plan (last paragraph); and

↳ *“The fulfilment of the performance indicators is conditional upon:*

- *Compliance with the country’s commitment to gradually increase the Romanian market sale price for domestic gas production to reach the convergence with the Romanian market sale price for import gas until December 31, 2018. The Commitment has been undertaken by the Letter of Intent signed with the International Monetary Fund, and by the Memorandum of Understanding signed with the European*

Commission, integral part of the Precautionary Stand-By Arrangement signed with the International Monetary Fund and the European Commission;

- *ANRE compliance with legal provisions on adjusting the regulated income and underground gas storage tariffs.*

.....
In case, other circumstances or events beyond Romgaz control require it, the Governing Plan shall be amended/modified/supplemented accordingly as regards the level of the performance indicators” – item 4.7 Performance criteria and objectives of the Governing Plan (page 76 – last paragraph);

✂ contingencies beyond the control of the board of directors or of the company’s management that impede the fulfilment of the objectives and performance indicators included in the Governing Plan, such as:

- ↳ non- compliance of the calendar related to the gradual increase of the market sale price for domestic gas production considered when preparing and approving the Governing Plan;
- ↳ fiscal regulations with a significant impact on the company’s performances, such as:
 - extending after December 31, 2014 the period for applying the windfall tax for gas producers as a result of price deregulation;
 - the tax on special constructions as of January 1, 2014;
- ↳ the reduced national gas consumption,

it is necessary to modify the calculation method of the performance indicators, according to the provisions of the Governing Plan, namely to eliminate the effects of the external factors that are beyond the control of the company’s management, due to which “the objectives and performance indicators cannot be fulfilled”.

Below are the factors that might impede the fulfilment of the performance indicators and criteria:

1. Non-compliance of the calendar for increasing the domestic gas price

Subject to the Memorandum of Understanding signed with the European Commission and to the Letter of Intent signed on **14.09.2011** with the International Monetary Fund (item 26), integral part of the Precautionary Stand-By Arrangement for Romania signed with the IMF and the European Commission, Romania undertook to gradually eliminate the regulated prices for non-household and household consumers both for the natural gas and electricity sector during 2013-2015.

Therefore, the Romanian Government signed in **2012** a Memorandum setting the quarterly sale prices for gas from domestic production for the period December 1, 2012 – October 1, 2018, when the convergence with import prices had to be performed.

Government Decision (GD) no. 22 of **January 22, 2013** set the domestic gas purchase price for the regulated market for the period February 1, 2013 – October 1, 2014.

The General Meeting of Shareholders approved by Resolution no.16 of **September 25, 2013** the Company's Governing Plan for the period 2013 – 2017.

GD no.511 of **June 26, 2014** modified the prices that had to come into force as of July 1, 2014 and October 1, 2014.

GD no.816 of **September 22, 2014** modified the prices that had to come into force as of October 1, 2014.

Law no. 127 of **September 30, 2014** extended the “gas supply at a regulated price and under framework agreements” until “June 30, 2021 for household consumers”.

GD no. 5 of **January 7, 2015** sets that “until June 30, 2015 the acquisition price of gas from domestic production for household consumers and thermal energy producers, only for the gas quantity used for thermal energy production in cogeneration plants and in power plants for the use of population, is of 53.30 RON/MWh”.

GD no. 488 of **July 1, 2015** sets the price for the period July 1, 2017 – April 1, 2020.

Table below shows the comparative evolution of the gas sale price from domestic production established under the Memorandum by the Romanian Government and the prices approved/modified by Decisions of the Romanian Government:

Implementation date	Consumers	PRICE (RON/MWh)					
		Memorandum	GD 22/'13	GD 511/'14	GD 816/'14	GD 5/'15	GD 488/'15
01.12.2012	nonhousehold	49.0	49.0 ^{*)}				
	household	45.7	45.71 ^{*)}				
01.04.2013	nonhousehold	55.3	55.3				
	household	45.7	45.71				
01.07.2013	nonhousehold	63.4	63.4				
	household	48.5	48.5				
01.10.2013	nonhousehold	68.3	68.3				
	household	49.8	49.8				
01.01.2014	nonhousehold	72.0	72.0				
	household	50.6	50.6				
01.04.2014	nonhousehold	89.4	89.4				
	household	51.8	51.8				
01.07.2014	nonhousehold	109.0	109.0	89.4			
	household	53.3	53.3	53.3			
01.10.2014	nonhousehold	119.0	119.0	89.4	89.4		
	household	54.6	54.6	54.6	53.3		
01.01.2015	household	56.1				53.3	
01.04.2015	household	58.9				53.3	
01.07.2015	household	62.0					60.0
01.10.2015	household	64.1					
01.01.2016	household	67.1					
01.04.2016	household	71.7					
01.07.2016	household	76.5					66.0
01.10.2016	household	78.5					
01.01.2017	household	82.0					
01.04.2017	household	86.9					72.0
01.07.2017	household	93.0					
01.10.2017	household	96.5					
01.01.2018	household	99.2					
01.04.2018	household	106.3					78.0
01.07.2018	household	115.1					
01.10.2018	household	119.0					
01.01.2019	household						

01.04.2019	household	84.00
01.07.2019	household	
01.10.2019	household	
01.01.2020	household	
01.04.2020	household	90.0
01.07.2020	household	
01.10.2020	household	

*) – prices valid as of February 1, 2013.

As of July 1, 2014 the supply prices of gas from domestic production have been substantially modified as compared to those approved under the Memorandum that were considered when the directors drafted the Governing Plan and set the performance objectives and criteria.

The differences between the prices of the Memorandum and the prices set by government decisions for the period July 1, 2014 – October 1, 2018 are shown in the table below:

Implementation date	Consumers	Memorandum (RON/MWh)	GD (RON/MWh)	Differences (RON/MWh)	Differences (%)
01.07.2014	nonhousehold	109.0	89.4	-19.6	-18.0
	household	53.3	53.3	-	-
01.10.2014	nonhousehold	119.0	89.4	-29.6	-24.9
	household	54.6	53.3	-1.3	-2.4
01.01.2015	household	56.1	53.3	-2.8	-5.0
01.04.2015	household	58.9	53.3	-5.6	-9.5
01.07.2015	household	62.0	60.0	-2.0	-3.2
01.10.2015	household	64.1	60.0	-4.1	-6.4
01.01.2016	household	67.1	60.0	-7.1	-10.6
01.04.2016	household	71.7	60.0	-11.7	-16.3
01.07.2016	household	76.5	66.0	-10.5	-13.7
01.10.2016	household	78.5	66.0	-12.5	-15.9
01.01.2017	household	82.0	66.0	-16.0	-19.5
01.04.2017	household	86.9	72.0	-14.9	-17.1
01.07.2017	household	93.0	72.0	-21.0	-22.6
01.10.2017	household	96.5	72.0	-24.5	-25.4
01.01.2018	household	99.2	72.0	-27.2	-27.4
01.04.2018	household	106.3	78.0	-28.3	-26.6
01.07.2018	household	115.1	78.0	-37.1	-32.2
01.10.2018	household	119.0	78.0	-41	-34.5

If in 2015 the average price differences for household consumers were of 6%, in the following years the differences escalate from approx. 14% in 2016 to 21% in 2017 and 30% in 2018.

The regulation of sale prices for domestic gas production at a level below the figures provided in the Memorandum, prices that have been considered when drafting the Governing Plan, has a significant negative impact on the following performance indicators:

- (1) revenue, (2) EBITDA, (3) labour productivity and (4) operating expenses to RON 1000 operating income.

The effect of modifying the price growth schedule on the non-fulfilment of performance indicators is also emphasized by the high weighing factor of the four indicators, summing up 65%.

2. Fiscal regulations with significant impact on company performance

2.1. Windfall tax for gas producers as a result of price deregulation

Government Ordinance no. 7/January 23, 2013 sets a windfall tax for gas producers as a result of price deregulation and it has a “60% share from the additional income [...] out of which royalties relating to this income are deducted as well as investments in the upstream sector”.

Art.7 of the above mentioned Ordinance provides that “the windfall tax set by this ordinance applies to additional income obtained before December 31, 2014 inclusively”.

The Governing Plan was drawn up in 2013 and it took in consideration the legislation in force hence also the Government Ordinance no.7/2013 which provides charging a windfall tax only up to December 31, 2014 inclusively.

By Government Emergency Ordinance no. 80/December 10, 2014 “the term provided in art. 7 of Government Ordinance no. 7/2013 regarding the windfall tax for gas producers as a result of price deregulation in the gas sector, as subsequently amended and supplemented, is extended to December 31, 2015 inclusively”.

By Government Emergency Ordinance no.57/ December 9, 2015 (art.29), “The term provided in art. 7 of Government Ordinance no.7/2013 regarding windfall tax for gas producers as a result of price deregulation in the gas sector, as subsequently amended and supplemented, is extended to December 31, 2016 inclusively”.

The amount of the windfall tax for 2014 was RON **376.7 million** and the one for January-October 2015 was RON **294.8 million**.

2.2. Tax on special constructions

By Government Emergency Ordinance no.102 /November 14, 2014 a tax on special constructions was set which “is calculated by applying 1.5% on the value of existing constructions under tax payers’ property on December 31 of the previous year”.

The issuance of this regulation after the preparation and approval of the Governing Plan by the shareholders, with a negative impact on the financial status of the company, has an implicit negative impact on the performance indicators also.

By Law no.11/January 8, 2015 on the approval of Government Emergency Ordinance no.102/ November 14, 2013 for the amendment and supplementation of Law no.571/2003 on the Fiscal Code and regulation of some fiscal-financial measures, the tax on special constructions, decreased starting with 2015 from 1.5% to 1% of the value of existing constructions under tax payers’ property on December 31 of the previous year.

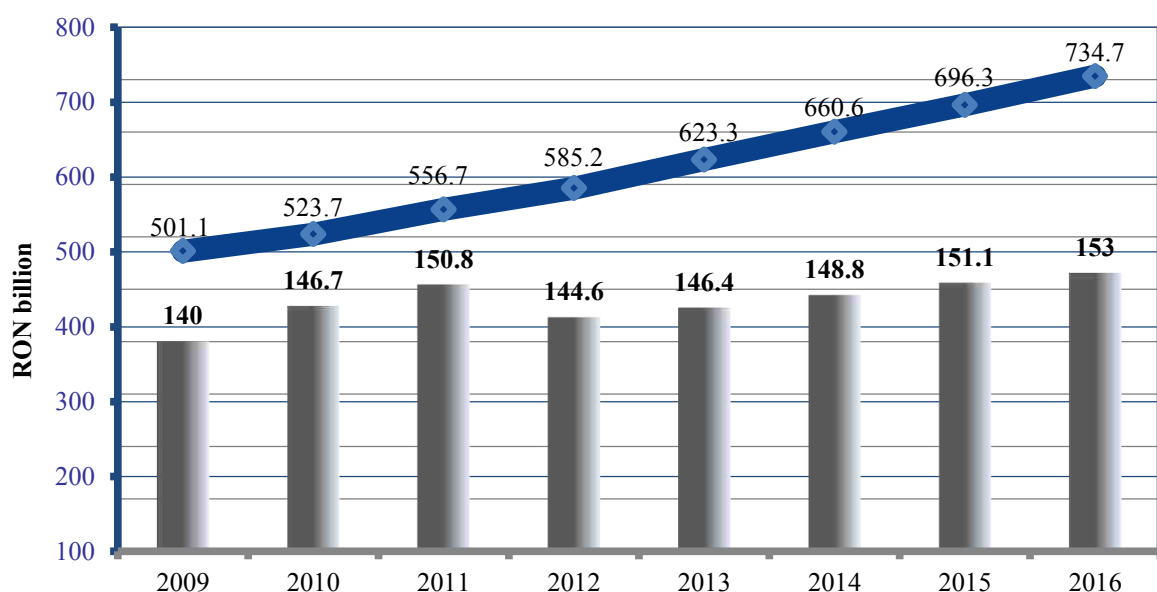
The amount of tax on special constructions for 2014 was RON **91.6 million** and for 2015 was RON **65.3 million**.

3. Decrease in natural gas consumption at national level

Considering that even though Romgaz has an oligopoly or even duopoly position and because there are no technical conditions yet for Romania to export gas, Romgaz sales and the other economic-financial indicators of the company implicitly are strongly dependent on the gas consumption on the domestic market.

The starting point of the market analysis, performed for the substantiation of Romgaz gas production and gas import respectively, analysis which was necessary for drawing up the objectives and indicators of the Governing Plan, was the official information on the evolution of energy consumption in general and of gas consumption in particular. Figure below shows

the evolution of gas consumption up to 2016 as it was presented by the National Forecast Commission:



Source: The National Forecast Commission, The projection of main macroeconomic indicators for 2013-2016 (February 2013), The energy balance forecast 2012-2020 (June 2012), ANRE 2009-2011 annual and 2012 monthly reports.

Table below shows a comparison between the forecast of gas consumption at national level and the actual gas consumption respectively pursuant to ANRE reports; for 2015 figures are estimated:

	<i>*billion MWh*</i>		
	2013	2014	2015
Forecasted consumption	146.4	148.8	151.1
Actual consumption	132.6	127.6	123.7
Differences:			
*relative (billion MWh)	-13.8	-21.2	-27.4
*absolute (%)	-9.4	-14.2	-18.1

The gas consumption considerably lower than the forecasted one has a significant negative impact on the revenue all the more so as Romgaz was one of the main suppliers of import gas.

The directors informed the shareholders of the company about this risk and thus, under point 4.7 (1) of the Governing Plan they stated that one of the external factors that may significantly influence the performance indicators of the company is “*the decrease in natural gas and electricity demand as a direct result of the increase of sale price of domestic gas and electricity production pursuant to the deregulation calendar undertaken by Romania*”, emphasizing in the same time that “*The first consequence of this risk will materialize in the decrease or even disappearance from the market of import gas with direct implications on the company revenue and profit implicitly*”.

Due to the above mentioned, both regarding the provisions of the Director Agreement and of the Governing Plan and the objectivity of the influencing factors causing the impossibility to achieve the performance objectives and indicators, it is necessary to modify their calculation method namely to eliminate the effect of the external factors both from the outcome of previous years, 2013, 2014 and 2015 and the outcome of the reporting periods.

Therefore, the calculation of individual indicators “Revenue”, “EBITDA”, “Labour Productivity” and “Operating expenses to RON 1000 operating income” shall be done taking in consideration the following corrections:

- 1) reducing expenses with the equivalent value of the tax on special constructions (2014, 2015 and beyond);
- 2) reducing expenses with the equivalent value of the windfall tax for gas producers as a result of price deregulation (2015 and beyond);
- 3) reducing income and expenses with the value of import gas sales and purchase (2013, 2014, 2015 and beyond);
- 4) increase of income and expenses relating to domestic gas sales taking into consideration the compliance with the calendar of gradual elimination of regulated prices for household and non-household consumers both for the gas sector and the electricity sector (2013, 2014, 2015 and beyond).

Table below shows the four individual indicators with and without corrections, respectively for 2013 - 2016:

No.	Specifications	M.U.	2013	2014	2015	2016
1. Revenue						
1.1	*actual/planned	RON million	3.894	4.493	4.053	3.824
1.2	*recalculated	RON million	3.442	4.675	4.943	4.997
1.3	Difference (1.2-1.1)	RON million	-452	+182	+890	+1.173
1.4	Difference (1.3/1.1)x100	%	-11,61	+4,05	+21,96	+30,67
2. EBITDA						
2.1	*actual/planned	RON million	2.284	2.864	2.590	2.279
2.2	*recalculated	RON million	2.261	3.207	3.777	3.755
2.3	Difference (2.2-2.1)	RON million	-23	+343	+1.187	+1.476
2.4	Difference (2.3/2.1)x100	%	-1,01	+11,98	+45,83	+64,77
3. Labour Productivity (W) calculated as a ratio between revenue and no. of employees						
3.1	*actual/planned	RON thousand	618	720	655	598
3.2	*recalculated	RON thousand	547	750	798	781
3.3	Difference (3.2-3.1)	RON thousand	-71	+30	+143	+183
3.4	Difference (3.3/3.1)x100	%	-11.49	+4.17	+21.83	+30.60
4. Operating expenses on RON 1000 operating income						
4.1	*actual/planned	RON	607	595	611	640
4.2	*recalculated	RON	556	542	454	454
4.3	Difference (4.2-4.1)	RON	-51	-53	-157	-186
4.4	Difference (4.3/4.1)x100	%	-8,40	-8,91	-25,70	-29,06

Following are the main financial indicators provided in the 2016 Income and Expenditure Budget and the corrected ones:

No.	Indicators	M.U.	2016 IEB Indicators	Corrected Indicators	Differences	
0	1	2	3	4	5=4-3	6=5/3x100
1.	Revenue	RON thousand	3,495,859	4,566,738	1,070,879	+30.6%
2.	Operating income*)	RON thousand	3,778,637	4,849,517	1,070,880	+30.6%
3.	Operating expenses*)	RON thousand	2,440,832	2,186,941	-253,891	-10.4%
4.	Gross profit	RON thousand	1,238,218	2,562,988	1,324,770	+106.7%
5.	Net profit	RON thousand	1,001,700	2,114,507	1,112,807	+111.1%
6.	EBITDA	RON thousand	1,949,495	3,274,266	1,324,771	+68.0%
7.	Operating expenses to RON 1000 operating income*)	RON	646.0	451.0	-195.0	-30.2%
9.	Labour productivity	RON thousand revenue/employee	547.6	715.3	165.7	+30.3%

*) – without adjustments and provisions

Below are the estimated values of performance indicators and criteria for 2016, taking in consideration the above mentioned corrections:

No.	Specifications	M.U.	Weighting coefficient	Performance criterion	Average values ('13-'15)	Target values	2016 Program	Achievement rate	Percentage
0	1	2	3	4	5	6	7	8	9
1.	EBITDA	RON thousand	0.25	+4.5%	3,081,746	3,220,424	3,274,266	101.7	25.43
2.	Revenue	RON thousand	0.20	+6%	4,352,906	4,614,080	4,566,738	99.0	19.80
3.	Labour productivity	RON thousand/employee	0.10	+6%	697.5	739.4	715.3	96.7	9.67
4.	Operating expenses on RON 1000 operating income	RON	0.10	-6%	510.6	507.5	451.0	112.5	11.25
5.	Volume of geological resources	Million CM	0.10	+1%	2,279.3	2,302.1	2,600.0	112.9	11.29
6.	Gas production decline	%	0.15	1.5%	5,412.0	5,331.1	4,567.0	85.7	12.86
7.	Outstanding payments	RON Thousand	0.10		0	0	0	110.0	11.00
* Performance criteria and objectives achievement degree									101.30

Note: Values on “Weighting coefficient” and “Performance criterion” are those undertaken in Director Agreements.

As a result, we submit for analysis and for further approval the proposal to modify the calculation method of the performance indicators, namely to eliminate the effects of the influence of external factors that are beyond the control of the company management due to which *“the performance objectives and indicators cannot be achieved”*.

BOARD OF DIRECTORS CHAIRPERSON,

Aurora Negruț

