

**Concise assessment of the standing of KGHM Polska Miedź S.A.  
for financial year 2014, including an evaluation of the internal control  
system and the Company's significant risk management system**

*(Approved by Resolution No. 12/IX/15 of the Supervisory Board of KGHM Polska Miedź S.A. dated 16 March 2015)*

March, 2015

*Translation from the original Polish version. In the event of differences resulting from the translation, reference should be made to the official Polish version.*

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# **Concise assessment of the standing of KGHM Polska Miedź S.A. for financial year 2014, including an evaluation of the internal control system and the Company's significant risk management system**

## **Introduction**

In accordance with chapter III point 1 sub-point 1) of the „Code of Best Practice for WSE Listed Companies” the Supervisory Board of KGHM Polska Miedź S.A. hereby presents a concise assessment of the Company's standing, including an evaluation of the risk management system and the internal control system for the Company. This assessment has been prepared based on documents submitted by the Management Board, discussions held with the participation of the Management Board and other individuals invited to attend meetings of the Supervisory Board, and also takes into account the financial statements and the reports of the Management Board on the Company's activities, and based on the conclusions from the audit of the Company's accounts by a Certified Auditor.

## **1. Economic results of KGHM Polska Miedź S.A. in 2014**

### **1.1 Mine and metallurgical production**

Mine production in the Company, in comparison to 2013, was lower by 2% (421.3 thousand tonnes of Cu in concentrate), alongside a decrease in copper content in extracted ore (due to work being performed in areas of lower copper content – the average copper content in extracted ore amounted to 1.53% as compared to 1.57% in 2013) which was offset by increased ore extraction (due to an increase in daily extraction on working days, and to intensified work on statutorily free days).

The volume of electrolytic copper production increased by 2% as compared to 2013 and was the highest result in the history of the Company: 576.9 thousand tonnes. This level was achieved despite the maintenance shutdown of smelter equipment at the Legnica smelter/refinery. The level of production was maintained as a result of the higher processing of own concentrate as well as of purchased copper-bearing materials, which enabled the efficient use of existing production capacity.

In comparison to 2013, there was a substantial increase in the amount of metallic gold produced (by 2.4 times) and for the first time in KGHM's history reached the level of 2 575 kg (an increase in the share of production from purchased concentrates), alongside higher metallic silver production by 95 t, ending the year at 1 256 t.

### **1.2 Macroeconomic conditions in 2014**

In 2014, the average annual price of copper on the London Metal Exchange (LME) was 6 862 USD/t, which was 6% lower than in 2013.

The silver price experienced a much worse situation in 2014, falling around 20% and averaging 19.08 USD/ounce.

The average annual USD/PLN exchange rate (per the NBP) in 2014 amounted to 3.15 USD/PLN and was slightly lower than in 2013 (3.17 USD/PLN).

### **1.3 Sales revenue**

In 2014, there was a decrease in the volume of copper sales by 4% as compared to 2013, due to the lower sale of stored, finished products than in 2013. In 2013, the Company sold products which it produced itself and decreased the level of inventories, and also sold its own copper concentrate.

Silver sales volume amounted to 1 262 t and was higher by 1% as compared to 2013, while gold sales increased by nearly 2.4-times and amounted to 2 530 kg. The substantial increase in gold sales was due to the higher production of this metal due to the processing of purchased copper-bearing materials which among others contained a high level of gold.

Revenues from the sale of KGHM Polska Miedź S.A.'s products in 2014 amounted to PLN 16 492 million, and were lower by 10% than revenues achieved in 2013. The main reasons for the decrease in revenues were the lower volume of copper sales by 21 thousand tonnes and the fall in copper and silver prices in the global market.

Revenues from the sale of copper and copper products were lower by 8%. Revenues from silver sales were lower by 23% as compared to their level in 2013, while revenues from gold sales were 2.3-times higher.

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The value of revenues from sales in 2014 reflects the positive result from the settlement of hedging instruments in the amount of PLN 531 million (in the prior year PLN 450 million).

### **1.4 Operating costs**

The Company's operating costs in 2014 amounted to PLN 13 120 million and were lower as compared to 2013 by 6% or PLN 850 million, mainly due to the lower volume of copper sales by around 21.2 thousand tonnes and to lower expenses by nature.

The decrease in 2014 of expenses by nature by PLN 161 million as compared to 2013 was mainly due to the lower minerals extraction tax (-PLN 336 million) alongside a higher value of consumed copper-bearing materials by PLN 217 million (due to the higher volume consumed by 15 thousand tonnes of Cu with a lower purchase price).

Expenses by nature, excluding purchased copper-bearing materials and the minerals extraction tax, were lower by PLN 42 million. Expenses by nature were impacted by:

- lower external services costs (-PLN 138 million) – mainly due to the lower scope of mine development work (-PLN 115 million),
- lower costs of materials used in production, as well as fuels and energy (-PLN 87 million),
- higher labour costs (+PLN 76 million) – mainly due to the higher provision for future employee benefits (+PLN 53 million) and a higher contribution to the employee retirement program, with a lower annual bonus expense,
- higher depreciation (+PLN 50 million) due to investments made in 2014, and
- higher taxation and fees excluding the minerals extraction tax (+PLN 32 million) due to the need to introduce from 1 January 2014 a mining usufruct fee (+PLN 30 million),

**Cost of producing copper in concentrate - C1** (*cash cost of producing payable copper, reflecting costs of ore extraction and processing, the minerals extraction tax, transport costs, administrative costs during the mining stage, and smelter treatment and refining charges (TC/RC), less the value of by-products*) was as follows: in 2013 1.78 USD/lb and in 2014 1.82 USD/lb. The increase in the C1 cost was mainly due to the lower valuation of precious metals (silver and gold) due to lower prices (+0.18 USD/lb). However the increase in the C1 cash cost was limited by the lower amount of minerals extraction tax paid (-0.10 USD/lb) and the lower cost of producing concentrates from ore mined by the Company.

### **1.5 Financial performance**

In 2014, the Company earned a profit in the amount of PLN 2 414 million. The decrease in profit by PLN 644 million or by 21% as compared to profit earned in 2013 was mainly due to market-related factors (metals prices, exchange rate), over which the Company did not have a significant impact.

The main factors affecting profit as compared to 2013 were:

- lower revenues from sales of basic products (Cu, Ag, Au) by PLN 1 761 million, due among others to lower metals prices (-PLN 1 446 million), a lower volume of copper sales with higher silver and gold sales (-PLN 273 million) and a less advantageous USD/PLN exchange rate (-PLN 42 million),
- a decrease in total cost of products sold by PLN 698 million, including a lower minerals extraction tax by PLN 236 million and a decrease in other costs due to a lower level of sales,
- the impact of hedging transactions (+PLN 279 million), of which due to the measurement and realisation of derivatives (+PLN 198 million) and to the adjustment to sales revenue (+PLN 81 million),
- lower income tax by PLN 190 million due to the lower tax base.

### **1.6 Assets, Equity and Liabilities**

As at 31 December 2014, total assets amounted to PLN 32 312 million, an increase by PLN 3 274 million or by 11% as compared to the end of 2013.

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The increase in the value of assets was due to development-related activities performed in accordance with the strategy, and is mainly in respect of increases in the following:

- property, plant and equipment and intangible assets, due to investments carried out (+PLN 2 056 million), and
- an increase in receivables due to loans granted to subsidiaries (+PLN 1 787 million).

At the same time the increase in assets was limited as a result of a decrease in the value of derivatives (-PLN 357 million), trade receivables (-PLN 208 million) and non-financial receivables (-PLN 166 million).

In terms of equity and liabilities the share of equity decreased from 80% to 75%.

This change was mainly due to an increase in:

- the amount of borrowings by PLN 985 million, mainly due to the loan instalment drawn from the European Investment Bank, which at the end of 2014 amounted to PLN 1 058 million (PLN USD 302 million).
- the provision for future mine decommissioning costs by PLN 509 million as a result of a decrease in the nominal discount rate.
- liabilities due to future employee benefits by PLN 423 million, which was also mainly due to a decrease in the discount rate.

### 1.7 Selected financial ratios

	2013	2014
Return on assets (ROA) (%)	10.5	7.5
Return on equity (ROE) (%)	13.1	9.9
Quick liquidity	0.8	0.7
Current liquidity	1.5	1.3
Debt ratio (%)	19.8	24.9
Durability of financing structure (%)	87.1	88.1
Net debt / EBITDA	0.2	0.5

The decrease in net profit as compared to 2013 led to a deterioration in the profitability ratios: ROA (from 10.5% to 7.5%) and ROE (from 13.1% to 9.9%).

The decrease in the liquidity ratios as compared to 2013 was mainly due to the decrease in current assets, in particular trade receivables and derivatives. The liquidity ratios are currently at a safe level.

The increase in the debt ratio reflects the increase in the use of leverage. The level of debt remains however substantially lower than the average for the sector. The high and virtually unchanged ratio showing the durability of the financing structure confirms the long-term nature of the Company's borrowing structure.

The ratio Net debt/EBITDA demonstrates the sound financial condition of KGHM Polska Miedź S.A. in accordance with the Company's Financial Liquidity Management Policy, which assumes that this ratio will remain below the level 2.0.

## 2. Company strategy and mission

Consistent implementation of the Strategy of KGHM Polska Miedź S.A. for the years 2009-2018, adopted on 23 February 2009, enabled the Company to achieve its key business goals and become a global mid-tier producer of copper at the level of 700 thousand tonnes.

As a result of achieving its strategic vision, KGHM Polska Miedź S.A. provided its shareholders with full value for their investment, as is demonstrated by the 33% increase in the TSR (Total Shareholder Return) index, with the highest level of returns amongst KGHM's peer global mining companies in terms of cost competitiveness and production.

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In terms of improving efficiency (Pillar I) we were successful at reversing the trend of rising costs. Since 2012 the Company has recorded an average annual decrease in costs of approx. 2% (i.e. the cost of producing electrolytic copper prior to deducting for by-products and after deducting the mineral extraction tax in KGHM Polska Miedź S.A.), though reducing production costs remains an enormous challenge for KGHM Polska Miedź SA. The key initiatives aimed at improving the cost efficiency of copper production are mainly projects involving the development and implementation of innovative technologies, as well as actions aimed at optimising production processes in the core business.

In 2014, we continued to invest in new technology, mainly with respect to the development of automated mining technology for the geological conditions encountered in the mines of KGHM Polska Miedź S.A., as well as with respect to the Pyrometallurgy Modernisation Program at the Głogów smelter/refinery.

Of particular importance are the actions underway with respect to research and innovation, in which KGHM Polska Miedź S.A. is aiming at an organisational model based on knowledge, concentrating mainly on improving production efficiencies, developing new technology in the fields of mining, ore processing and non-ferrous metals metallurgy, the effective management of industrial risk and development of the resource base.

In the long term, we plan on introducing the concept of the so-called Intelligent Mine, followed by a fully-integrated „Intelligent Production Line” ensuring safety and technological effectiveness, as well as the possibility to efficiently and flexibly manage the entire production process.

In terms of resource base development (Pillar II) the Company took a fundamental step forward as a result of expansion overseas (via acquisitions). This global expansion enabled the Company to enhance its position amongst global copper producers. The total resource base of KGHM Polska Miedź S.A. increased by over 40% (or 12 million tonnes), putting the Company into 4th place globally in terms of total copper resources. At the same time copper production by the KGHM Group increased by nearly 25% starting from 2012, advancing the Company from 10th to 8<sup>th</sup> place in terms of global copper production. Moreover, KGHM Polska Miedź S.A. gained the ability to diversify the resource base and costs structure of the KGHM Group thanks to new mining assets rich in metals besides copper (mainly molybdenum and gold) which in part are mined by the open-pit method, which is decidedly cheaper than underground mining.

The first step in achieving the Company's vision as a global copper producer was taken in 2010. This is when we purchased 51% of the special purpose company KGHM AJAX MINING INC., created in partnership with the Canadian company Abacus Mining & Exploration Corporation, to advance the Afton-Ajax copper and gold project located in British Columbia, Canada. Following the publication of a Bankable Feasibility Study for the Afton-Ajax deposit, in 2012 the Company made use of the option to acquire an additional 29% of the shares of KGHM AJAX MINING INC. The project assumes annual copper production of 50 thousand tonnes, with gold production of 100 thousand ounces.

As a result of the acquisition in 2012 of the Canadian mining company Quadra FNX (today KGHM INTERNATIONAL LTD.) KGHM Polska Miedź S.A. became the owner of attractive deposits rich in copper, silver, nickel, molybdenum and other precious metals located mainly in North and South America:

- the active open-pit mines Robinson (USA) and Franke (Chile), and the underground mine Morrison (in the Sudbury region of Canada),
- mine projects under construction, such as the open-pit mine Sierra Gorda in Chile - the Company's most important development project, being advanced on one of the world's largest deposits of copper and molybdenum – on 30 July 2014 the Sierra Gorda mine commenced production. The official opening ceremony took place on 1 October 2014. Full production capacity planned for the first phase of the project, allowing for the production of 120 thousand tonnes of copper per year (processing of 110 thousand tonnes of ore daily) is scheduled to be achieved by mid-2015,
- mine projects in the pre-operational stage such as the Victoria underground copper and nickel mine in Canada, and
- exploration projects, including in the Sudbury region of Canada and Malmbjerg in Greenland.

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The diversified portfolio of geological-mining projects currently held by KGHM Polska Miedź S.A. are at various stages of development and ensure continued growth by the Company. The global copper ore resources controlled by KGHM Polska Miedź S.A. guarantee the Company's stability and continuity of production for the next 40 years.

Actions undertaken to secure access to the resource base include continuation of the Deep Głogów project in Poland (on 1 April 2014, the G-25 mining section was the first to commence operations in the Deep Głogów deposit) as well as exploration projects (exploring for and documenting deposits) in Poland and Germany which are at various stages of geological work, based on and in accordance with the terms set forth in the respective concessions and agreements on setting mining usufruct rights.

With respect to diversifying sources of revenues and securing competitively-priced energy (Pillar 3) projects were continued whose completion will gradually assure the energy needs of KGHM Polska Miedź S.A. from its own resources and will also lead to diversification of the energy generation portfolio as well as significantly reduce the Company's exposure to climate policy risk and to changes in fuel and electricity prices.

In the years 2010-2014 the Company built two gas-steam blocks at the Głogów and Polkowice power plants. 3 November 2014 marked the official start of the generation of electricity and heat through highly-efficient co-generation. This investment will enable optimisation of power and heating costs in KGHM Polska Miedź S.A. through the associated generation of power using internal generation capacity at the level of approx. 560 GWh, all of which is designated to meet the power needs of the Company. Thanks to the benefits derived from the use of yellow certificates, the cost of generating electricity by the blocks is below market price. The output of the blocks covers around one-fourth of the power needs of KGHM Polska Miedź S.A. and will result in lower greenhouse gas emissions by 40% as compared to emissions from conventional coal-fired sources (today, energy production by Energetyka Sp. z o.o. from that subsidiary's own resources accounts for 10% – approx. 250 GWh – of the Company's total annual power needs of approx. 2 600 GWh).

With respect to cooperation with partners from the energy sector, in 2014 KGHM Polska Miedź S.A. continued to participate in the most important energy projects on a national scale. It is expected that participation in these projects will lead to secure energy supplies for the Company at an optimum price. With respect to the project to build in Poland an approx. 3 000 MWe nuclear power plant, on 3 September 2014, a Shareholders Agreement was signed by KGHM Polska Miedź S.A. („KGHM”), PGE Polska Grupa Energetyczna S.A. („PGE”), TAURON Polska Energia S.A. („TAURON”) and ENEA S.A. („ENEA”) for the company PGE EJ1 sp. z o.o. This company, PGE EJ 1 sp. z o.o., is responsible for the preparation and execution of the investment to build and operate the first Polish nuclear power plant ("Project").

The business activities of KGHM Polska Miedź S.A. as one of the most important companies in the region is carried out with a proper respect for the principles of sustainable development, and in full consciousness of the responsibilities of the Company as regards the impact of its mining and metallurgical operations on the communities and the natural environment where it functions (Pillar IV). KGHM's commitment to sustainable development and corporate social responsibility is based on the implementation of its approved CSR (corporate social responsibility) strategy. This strategy comprehensively deals with the social, ethical and environmental aspects of KGHM's business activities and its full responsibility and transparency in managing its relationships with our stakeholders, such as employees, customers, shareholders, suppliers and local communities.

Building the fundamentals of the Company's long-term development was supported by actions aimed at enhancing organisational efficiency and management skills as well as actions in the field of human resources development, access to and processing of information and supervision and management of Group companies (Pillar V). In 2014 the process of integration was continued within the KGHM Group, and work began on developing a conceptual framework and model of a Global Knowledge Center, including the creation of a management model and determining areas which are managed and supervised from the Head Office of the KGHM Group. Design work and full implementation of the Global Knowledge Center concept will be carried out over the next five years.

With respect to human resources management, work was continued on the project to transform the HR function, aimed at transforming it to a role of effective support of strategic organisational ambitions,

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strengthened by a change in the function of the HR role from a purely administrative one into one which provides support, partnership and advice in key areas of the HR process such as management by goals, education and development, strategic planning of human resources, recruitment, talent management, and being a HR Business Partner.

### **3. New Strategy of KGHM Polska Miedź S.A. for the years 2015-2020 with an outlook to 2040**

The successful accomplishment of the 2009 Strategy was an incentive to define new directions for the Company's development and aspirations for the next several decades. On 26 January 2015 the Company's Supervisory Board adopted the Strategy of KGHM Polska Miedź S.A. for the years 2015-2020 with an outlook to 2040 as submitted by the Management Board.

The mission of KGHM Polska Miedź S.A. is the development of a global resources Group, created by people with passion and skill. The long-term vision of KGHM Polska Miedź S.A. assumes that the Company will gradually increase its competitive advantage through the development and introduction on an industrial scale of new technologies that will create an opportunity for a technological breakthrough in the industry. The strategic objective of KGHM Polska Miedź S.A. is to develop and implement on an industrial scale modern technologies which are critical to developing the world's first intelligent mine based on neural networks.

The main objective of the new strategic outlook for the years 2015-2020 is to achieve annual production capacity of over 1 million tonnes of copper equivalent and to continue work aimed at improving mine operating efficiency.

The Strategy for the years 2015 – 2020 with an outlook to 2040 is based on 3 main pillars:

<b>Pillar I. Resource Base Development</b>	As part of its exploration and acquisition activities, the Company plans to replace every mined tonne of copper with three tonnes of copper in new resources. This will ensure the long-term operational prospects of the Company and an enhanced position on the cost curve. The Company will concentrate on exploration in areas near the Company's current operations and on the search for low-cost assets in geopolitically-stable regions. The planned development of KGHM Polska Miedź S.A. resource base will ensure long-term mining activities and secure higher production volume.
<b>Pillar II. Production Assets Development</b>	According to the Strategy, the Company plans to invest PLN 27 billion over the period from 2015 to 2020. These funds will be allocated to developing the current portfolio of investment projects, including programs to develop the core business in Poland and those leading to the operational commissioning of resource projects in Poland and abroad (Deep Głogów, Victoria, Sierra Gorda phase II, Sierra Gorda oxides project and Ajax). Completion of its investments projects will enable a substantial increase in Group production capacity and enhance its position on the global cost curve of copper producers. KGHM Polska Miedź S.A. is committed to efficiently allocating financial resources and developing resource investment projects which have the highest rate of return.
<b>Pillar III. Production</b>	KGHM Polska Miedź S.A. aims to ensure stable production levels while optimising production costs and maintaining the highest safety level. Under the Strategy of KGHM Polska Miedź S.A. for the years 2015-2020 the Company plans to increase the annual volume of mined ore from the mines of KGHM Polska Miedź S.A. in Poland. Moreover, the Company plans to achieve full phase I production capacity by the Sierra Gorda project, i.e. annual copper production of 120 thousand tonnes by mid-2015. Under the new strategy the Company plans to commence phase II of the project and to commence processing of the oxide ore from the Sierra Gorda mine, which will increase efficiency and ensure higher copper production from the mine.



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The three pillars of KGHM's activities in the years 2015–2020 are based on four supporting strategies:

<b>Global organisation and skills development strategy</b>	Achievement of an optimum model for the management and supervision of business processes within the global KGHM Group.
<b>Financial strategy</b>	Ensure stable financing for the activities of the KGHM Group, enhance the ability to operate in challenging economic conditions, support development and increase efficiency.
<b>Corporate social responsibility strategy</b>	Strengthen the position of KGHM Polska Miedź S.A. as a stable, growing and trustworthy partner, caring for the common good and the sustainable management of resources.
<b>Energy strategy</b>	Secure long-term energy prices and stable energy supply by ensuring sources of energy for production purposes, including from renewable resources. The strategy assumes the centralisation of energy efficiency initiatives, ensuring the possibility of purchasing energy for key companies of the Group in Poland and global power purchases at below-market prices.

Basic production and economic assumptions for the Group (reflecting the 55% share in the Sierra Gorda project) for the years 2015 – 2020:

<b>Production</b>	over 1 million tonnes of copper equivalent from our own resources by the year 2020
<b>Share of copper equivalent production from overseas assets</b>	an increase from 17% to 40% in 2020
<b>CAPEX</b>	PLN 27 billion in total capital expenditures, of which around 65% will be allocated for development projects; over half of the capital expenditures will be invested in Poland
<b>EBITDA</b>	expected increase by 2020 of 70% as compared to 2014
<b>C1 cost</b>	planned decrease by 2020 of C1 cash cost of around 10 % as compared to 2014
<b>Net debt /EBITDA</b>	will be maintained at a safe level in the range of 1-2

The Strategy was developed based on the following assumptions:

- average copper price in the period 2015 – 2020 of 7 600 USD/t (2015 - 6 800 USD/t),
- average silver and molybdenum prices in the period 2015 – 2020 respectively 21 USD/oz t (2015 – 18 USD/oz t) and 12 USD/lb (2015 – 12 USD/lb),
- average assumed exchange rate of the PLN versus the USD in the period 2015 – 2020 of PLN 3.00 (2015 – PLN 3.30)

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In 2015 the Company will focus on achieving the following priorities under the Strategy:

<b>Exploration work</b>	<ul style="list-style-type: none"> <li>- planned exploration work in the Głogów, Retków-Ścinawa, Synklina Grodziecka, Konrad, Weisswasser II, Stojanów and Puck concessions</li> <li>- exploration work on the mining assets outside Poland, in particular Sierra Gorda and Ajax</li> </ul>
<b>Sierra Gorda Project</b>	<ul style="list-style-type: none"> <li>- achievement of target phase 1 production capacity - 110 kt of ore per day</li> <li>- completion of the feasibility study for the oxide ore project</li> </ul>
<b>Victoria Project</b>	<ul style="list-style-type: none"> <li>- preparations for shaft sinking</li> </ul>
<b>Ajax Project</b>	<ul style="list-style-type: none"> <li>- submitting an application for environmental permits</li> </ul>
<b>Pyrometallurgy Modernisation Program</b>	<ul style="list-style-type: none"> <li>- receiving technical approvals and construction permits</li> <li>- completion of the design phase with executory documentation</li> <li>- completion of the construction and development of the Flash Furnace and Electrical Furnace halls</li> </ul>
<b>Żelazny Most Development Project</b>	<ul style="list-style-type: none"> <li>- receipt of legally-binding Municipal Area Management Plans for the municipality of Polkowice to allow construction to begin</li> <li>- receipt of permits to develop the Main Facility to a crown height of 185 m a.s.l. in the municipalities of Rudna and Grębocice</li> </ul>
<b>Value Creation Plan</b>	<ul style="list-style-type: none"> <li>- implementation of initiatives in Poland and abroad</li> </ul>
<b>Workplace safety</b>	<ul style="list-style-type: none"> <li>- further improvement in the workplace safety ratio (LTIFR)</li> </ul>
<b>Financing of operations</b>	<ul style="list-style-type: none"> <li>- continuation of financial consolidation in the Group to reduce the average weighted cost of capital</li> </ul>
<b>Innovation policy</b>	<ul style="list-style-type: none"> <li>- research projects, including the mechanical mining of ore</li> </ul>

#### **4. Evaluation of the financial risk management system in the Company in 2014**

The KGHM Polska Miedź S.A. Group defines risk as uncertainty, being an integral part of the activities conducted and having the potential to result in both opportunities and threats to achievement of the business goals. The current, future, actual and potential impact of risk on the Group's activities is assessed. Based on this assessment, management practices are reviewed and adjusted in terms of responses to individual risks.

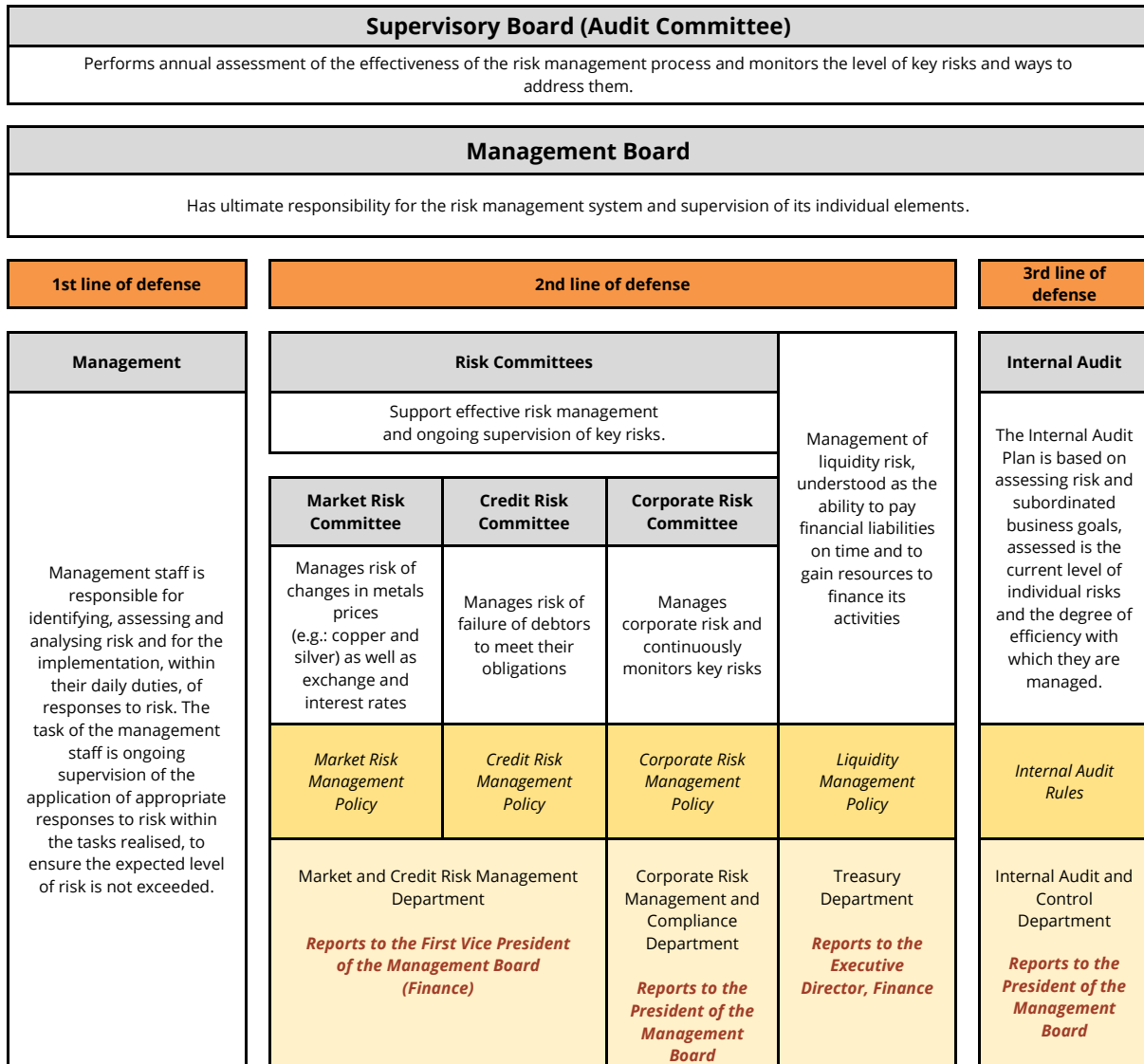
Under the Corporate Risk Management Policy and Procedure and the Rules of the Corporate Risk Committee approved in 2013, the process of corporate risk management in the KGHM Polska Miedź S.A. Group is consistently performed. Risks in various areas of the Group's operations are continuously identified, assessed and analysed in terms of their possible limitation.

Key risks undergo in-depth analysis in order to develop a Risk Response Plan and Corrective Actions. Other risks undergo constant monitoring by the Corporate Risk Management and Conformity Department, and in terms of financial risk by the Market and Credit Risk Management Department, the Treasury Department and the Financial Instruments Control and Reporting Unit.

Presented below is the organisational structure of risk management in the Company. The breakdown of rights and responsibilities applies best practice principles for Corporate Governance and the generally recognised model of three lines of defense.

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**Diagram 1. Organisational structure of risk management in KGHM Polska Miedź S.A.**



**Market, credit and liquidity risk**

The management of individual types of market, credit and liquidity risk is the subject of separate individual regulations in KGHM Polska Miedź S.A. and is covered by the following documents:

- Market Risk Management Policy and the Rules of the Market Risk Management Committee,
- Credit Risk Management Policy and the Rules of the Credit Risk Committee,
- Financial Liquidity Management Policy.

The goal of market, credit and liquidity risk management in KGHM Polska Miedź S.A. is to restrict the undesired impact of financial factors on cash flow and Company results in the short and medium terms and to build Company value over the long term. The management of these risks includes both the processes of risk identification and measurement as well as its restriction to acceptable levels. The process of risk management is supported by an appropriate policy, organisational structure and procedures applied in the Company.

In March 2014, a new Market Risk Management Policy in the KGHM Polska Miedź S.A. Group was approved, and representatives of KGHM INTERNATIONAL LTD. were added to the composition of the Market Risk Committee. These changes were aimed at setting principles and procedures with respect to market risk

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management in selected mining companies of the Group (KGHM Polska Miedź S.A., KGHM INTERNATIONAL LTD., FNX Mining Company inc., Robinson Nevada Mining Company, KGHM AJAX MINING INC., Sociedad Contractual Minera Franke). The Policy concerns exposure to the following market risks: volatility in metals prices, volatility in exchange rates, volatility in interest rates and volatility in prices of commodities other than metals.

The goals of market risk management at the Group level are achieved through their implementation in individual Group companies, through the coordination of these activities at the Parent Entity level, i.e. KGHM Polska Miedź S.A. Key tasks were centralised in the Company related to the process of market risk management in the Group (such as coordination of the identification of sources of exposure to market risk, proposing hedging strategies, contacting financial institutions in order to sign, confirm and settle derivatives transactions, and calculating measurement to fair value).

### **5. Evaluation of the internal audit and internal control systems**

The functions of internal auditing and internal control (institutional) is performed by an organisational unit in the structure of KGHM Polska Miedź S.A. – the Department of Internal Auditing and Internal Control. This unit was established on 1 July 2013 through the combination of the former Department of Internal Auditing and Department of Internal Control.

This joint department systematically evaluates and monitors the control mechanisms and identifies potential risks in individual processes occurring in the Company and in the entire Group, as well as uncovers irregularities and violations of existing procedures.

Auditing activities focus on assessing risk and evaluating and monitoring the functioning of the internal control systems in individual processes occurring in the Company and Group. Control activities focus in particular on uncovering irregularities and violations of existing procedures.

The system of internal auditing and internal control in KGHM Polska Miedź S.A. is based on the principle of independence, and may encompass virtually all areas of the Company's and Group's operations.

In 2014, the Department of Internal Auditing and Internal Control performed 38 various types of planned or ad hoc tasks. Three of the audits were performed with the support of an external company. Controls and audits were performed both in the divisions as well as in companies of the KGHM Polska Miedź Group, including those outside Poland.

As a result of audits performed in 2014, recommendations were implemented which eliminated ineffective controls mechanisms and minimised potential risks in analysed processes such as management of strategic investments, the selection of suppliers, management of deliveries of raw and other materials as well as of services, management of technical projects, waste management, setting transfer prices and management of current assets.

The controls performed uncovered irregularities and violations most often of a procedural nature (improper execution of internal regulations), improper operation of equipment, violation of employee obligations, and also irregularities in the execution of services by contractors on behalf of the divisions of KGHM Polska Miedź S.A. The post-control recommendations made in respect of the Controlled Parties were aimed at eliminating the identified irregularities and implementing corrective procedures.

The implementation of recommendations is continuously monitored by the Department of Internal Auditing and Internal Control and assessed by the Audit Committee of the Supervisory Board of KGHM Polska Miedź S.A.

### **6. Selected areas requiring attention**

#### **6.1 Consolidation of financing in the Group**

In 2014, the Company secured the availability of over PLN 14 billion in external financing, which fully covers the medium and long-term liquidity needs of the Company and Group. The external financing available is based on three pillars:

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- an unsecured, revolving syndicated credit facility in the amount of USD 2.5 billion with maturity falling on 11 July 2019 (with the option to extend it for another 2 years),
- an investment loan from the European Investment Bank in the amount of PLN 2.0 billion and a 12-year financing period,
- short-term bilateral loans in the amount of up to PLN 3.3 billion, with an availability period of up to 2 years.

In 2015 the priority is to organise and carry out the process of refinancing of the debt of KGHM INTERNATIONAL. The adopted Strategy of consolidating financing within the Group is aimed at reducing the average weighted rate of interest applied when borrowing.

### **6.2 Investment in Sierra Gorda**

In 2014, construction continued on the Sierra Gorda mine – expenditures incurred by the KGHM Polska Miedź S.A. Group related to financing the project in 2014 amounted to USD 666 million, of which USD 332 million was provided by KGHM Polska Miedź S.A., with the remainder coming from KGHM International Ltd.

In July the production of copper concentrate commenced, while work on commissioning the plant to produce molybdenum concentrate continued to the end of 2014. At the same time in 2014 design work began on preparing phase II of the investment, which is aimed at increasing processing capacity to at least 190 thousand tonnes of ore per day. Leaching tests were also carried out on the oxide ore as part of the Sierra Gorda Oxides project.

In 2015, Sierra Gorda will continue the aforementioned activities, including mainly with respect to:

- Achieving designed processing capacity, in terms of both copper and molybdenum production, which under phase I is expected by mid-year 2015,
- Continuing work on phase II of the mine's development, comprising the finalisation of the project technical execution contract and the selection of an optimal variant,
- Continuing work on the Sierra Gorda Oxides project, including:
  - finalising metallurgical testing and developing a report confirming the results achieved,
  - developing a detailed project design,
  - reviewing the expected capital expenditures, and
  - estimating critical risks, including water and power supply,
- Utilising synergies arising from advancing both projects (phase II, Oxides), including above all close cooperation to obtain environmental permits, as well as additional sources of energy.

Concurrently to the tasks mentioned above, work will be continued which is aimed at enhancing efficiency in both the short and long terms. Amongst these tasks the most important are initiatives involving optimisation of processes related to blasting, increasing the pit slope and utilising renewable sources of energy.

From the point of view of the project's Partners, another important aspect is ensuring financing, comprised of phase I to the end of the ramp-up period and the achievement by Sierra Gorda of stable, positive cash flow, as well as increased production capacity (phase II) and advancement of the Oxides project.

### **6.3 Pyrometallurgy Modernisation**

Completion of this Program will result in the creation of a functionally-integrated, cost-effective and environmentally-friendly metallurgical structure in KGHM Polska Miedź S.A. It is expected that KGHM Polska Miedź S.A. will gain long-term economic benefits from this program, including among others a decrease in the total unit cost of processing and higher revenues from the sale of additional amounts of silver, rhenium and refined lead. Moreover, thanks to the more than 50% decrease in emissions of dust and gas to the atmosphere there will be a very clear decrease in the environmental impact of the plant, and as a result the company's competitive position on the world market will improve.

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The updated budget for the Pyrometallurgy Modernisation Program project is PLN 2.1 billion. The completion of all deliveries and construction and assembly work necessary to commission the Flash Furnace (including sending copper concentrate through the modernised Flash Furnace installation) is planned by October 2016. The above projects do not affect the continuity of metallurgical production by KGHM Polska Miedź S.A. while developing the investment.

In 2015, the PMP project expects to achieve the following milestones:

- obtaining technical agreements and construction permits – second quarter 2015,
- completion of design work and construction documentation – first quarter 2015,
- completion of construction of the shaft furnace and electrical furnace halls – fourth quarter 2015.

### **6.4 Exploration projects**

In accordance with Pillar I of the Strategy, in terms of exploration and acquisitions, the Company expects to replace every tonne of mined copper with three tonnes of the metal in newly-documented resources. This will secure the Company's long-term operational outlook and improve its cost position. The Company will concentrate on exploration in the vicinity of its current mining operations in Poland and on searching for low-cost assets located in geopolitically-stable jurisdictions. The planned development of KGHM Polska Miedź S.A.'s resource base will ensure the the Company's long-term operational outlook while increasing the volume of production. The main priorities for 2015 are:

#### **The Victoria project**

In 2015 work will continue on engineering aimed at developing detailed technical documentation. At the same time work will continue related to building the surface infrastructure and sinking the mine shaft.

#### **The Ajax project**

Pursuant to the new project schedule, the project team plans to apply for environmental permits at the end of the first half of 2015 and for a mining permit in the second half of 2015. The adopted schedule foresees the construction of mine facilities to begin at the end of 2016.

#### **Exploration projects in Poland**

- Retków-Ścinawa – continuation of phase I drilling in accordance with the concession to explore and assess the copper ore deposit in the area of Retków-Ścinawa.
- Głogów – continuation of phase I drilling in accordance with the concession to explore and assess the copper ore deposit in the area of Głogów.
- Konrad – the commencement of geophysical and drilling work in accordance with the concession to explore and assess the copper ore deposit in the area of Konrad.
- Synklina Grodziecka – analysis of the results of geological work in the area of the Synklina Grodziecka concession.
- Stojanów – the commencement of phase I geophysical work in accordance with the concession to explore and assess the copper ore deposit in the area of Stojanów. This work will enable a decision to be made as to whether to conduct drilling.
- Weisswasser – advancement of phase II of the exploration project in the Weisswasser area. By mid-2015 a single drillhole will be made, and based on the results obtained from it a decision will be made as to the continuation of the project.
- Puck – the commencement of phase I geophysical work in accordance with the concession to explore and assess deposits of potassium-magnesium salt with associated mineral ores containing copper and rock salt in the vicinity of Puck. At the same time administrative and court proceedings are underway with an entity which is likewise seeking a concession in this area.

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**6.5 Strategy implementation**

An integral part of the Strategy is the Strategic Management Procedure in KGHM Polska Miedź S.A. which defines the process of its implementation. In 2015 the Company plans to develop a detailed Strategy Implementation Plan for the Company's new strategic outlook for the years 2015-2020 based on the adopted structure for breaking down the main strategy into executory strategies in the core business and strategies supporting the Company's core business.

The Strategy Implementation Plan will define the initiatives and associated projects and strategic actions which are key to achieving the strategic goals arising from the executory and supporting strategies, including a performance schedule and the allocation of required resources. The Strategy Implementation Plan will form the basis for monitoring and assessing achievement of the Strategy of KGHM Polska Miedź S.A. It is assumed that the Strategy Implementation Plan will be updated on an annual basis, in order to synchronise its work with the Company's adopted budgetary process.