

**Brief assessment of the standing of KGHM Polska Miedź S.A. for financial year 2013,  
including an evaluation of the internal control system  
and the Company's significant risk management system**

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## **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 brief 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 account books by a Certified Auditor.

### **1. Economic results of KGHM Polska Miedź S.A. in 2013**

#### **1.1 Mine and smelter production**

Mine production in the Company, in comparison to 2012, remained at a similar level (428.9 kt Cu in concentrate), while a decrease in copper content in ore (due to work in regions with lower copper ore mineralisation – average copper content in ore amounted to 1.57% versus the level of 1.59% in 2012) was offset by increased ore extraction (due to increased extraction on working days and to intensified work on statutorily free days).

The production of electrolytic copper in 2013 (565.2 kt) was also at a similar level to that of 2012. This high smelter production was achieved despite the smelter production line maintenance shutdown at HM Głogów II. Assisting in maintaining the level of production was the higher processing of own concentrate and the share of purchased copper-bearing materials in the form of scrap, blister copper and imported concentrate, which in 2013 amounted to 24%.

There were decreases in the production volumes of silver and refined lead (respectively by 9% and 3%) while the gold production increased (+16%). These changes are a result of the scale of electrolytic copper production and the type of raw materials used, as well as on market demand.

#### **1.2 Macroeconomic conditions in 2013**

In 2013 the global economy developed at a somewhat slower pace than in previous years. As a result the average annual price of copper on the London Metal Exchange (LME) in 2013 was 7 322 USD/t, meaning a decrease versus the prior year by 8%.

There were however volatile changes on the silver market, whose price in the first half of the year decreased by around 30%, and in 2013 was at an average level of 23.79 USD/ounce, meaning a decrease by 24% versus 2012.

The average annual USD/PLN exchange rate (per the NBP) in 2013 amounted to 3.17 USD/PLN and was lower versus the prior year by nearly 3% (3.26 USD/PLN).

#### **1.3 Revenues from sales**

In 2013, versus the prior year, the Company increased the volume of copper sales by 7.2 kt (1%). In addition approx. 25.3 kt dry weight (7.0 kt Cu) of copper concentrate was sold. Silver sales amounted to 1 250 t and were lower by 1% (16 t), while gold sales amounted to 1 057 kg and were higher by 16% (149 kg).

Total revenues from the sale of KGHM Polska Miedź S.A. products in 2013 amounted to PLN 18 285 million, and were lower by 11% than revenues achieved in 2012, mainly as a result of lower metals prices: copper on the London Metal Exchange (LME) and silver on the London Bullion Market (LBM) as well as to a decrease in the USD/PLN exchange rate. Revenues from the sale of copper and copper products were lower by 8%, while revenues from the sale of precious metals – silver and gold – were lower respectively by 26% and 8%.

The value of revenues from sales in 2013 reflect the positive result from the settlement of hedging instruments in the amount of PLN 450 million (in the prior year PLN 333 million).

#### **1.4 Basic operating costs**

In 2013, total expenses by nature versus 2012 were lower by PLN 738 million, i.e. by 5%, mainly due to the lower value of purchased copper-bearing materials by PLN 1 010 million due to a lower volume of consumption by 24 kt Cu and lower purchase prices.

Expenses by nature excluding purchased copper-bearing materials increased by PLN 272 million. Expenses by nature were impacted by the following:

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- higher calculated minerals extraction tax (+PLN 260 million) due to the fact that in 2013 the tax was in force for the full year while in 2012 it was in force from 18 April,
- higher external services (+PLN 159 million) – mainly due to an increase in the scope of mine development work (+PLN 56 million), higher maintenance costs due to the general maintenance performed at the Głogów II smelter (+PLN 27 million) and higher costs of external processing for the recovery of rhenium (+PLN 40 million),
- lower energy costs (PLN (62) million) – due to a decrease in the price of electricity by 9%.
- lower labour costs (PLN (41) million) – due to a lower annual bonus charge (in 2012 24%; in 2013 20%), and a lower provision for future employee benefits with a higher contribution to the ERP.

C1 cost (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: 1.34 USD/lb in 2012 and 1.78 USD/lb in 2013. Also having a negative impact on the C1 cost expressed in USD/lb, apart from the minerals extraction tax, was the strengthening of the zloty versus the USD from a level of 3.26 in 2012 to 3.17 in 2013.

### 1.5 Financial results

In 2013, the Company realised a profit in the amount of PLN 3 058 million. The decrease versus the result achieved in 2012 amounted to PLN 1 810 million (by 37%) and was mainly due to factors over which the Company did not have a significant impact:

- a change in the prices of basic products (a decrease in the price of copper by 8%, silver by 24%, gold by 16%.), which decreased revenues from sales by PLN 2 159 million,
- a change in the exchange rate from 3.26 USD/PLN to 3.17 USD/PLN (strengthening of the PLN by 3%) which decreased revenues from sales by PLN 593 million,
- an increase in the minerals extraction tax from PLN 1 327 million in 2012 to PLN 1 821 million in 2013 (+PLN 494 million), due to settlement of the tax for the full reporting period (in 2012 from April).

In addition profit was impacted by a decrease in the result on other operating activities due to the measurement and realisation of derivatives (-PLN 293 million) and to a change in adjustment to sales due to hedging (+PLN 117 million).

The negative impact of the above factors was partially offset by:

- a change in the result on exchange differences, which in 2013 was below PLN +1 million, while in the previous year it amounted to -PLN 565 million,
- lower income tax by PLN 411 million, due to the lower tax base,
- an increase in the volume of copper sales by 14.2 kt and gold by 149.4 kg alongside a decrease in silver sold by 16.4 t, which combined resulted in an increase in revenues from sales by PLN 349 million,
- a decrease in basic operating costs by PLN 126 million (excluding the aforementioned minerals extraction tax), mainly due to lower costs of purchased copper-bearing materials measured based on lower metals prices and exchange rate,
- a lower loss on the impairment of available-for-sale financial assets by PLN 68 million, mainly in respect of an impairment loss on the company Tauron Polska Energia S.A.

### 1.6 Selected financial ratios

	2012	2013
Return on assets (ROA) (%)	17.3	10.5
Return on equity (ROE) (%)	22.2	13.1
Quick liquidity	0.7	0.8
Current liquidity	1.5	1.5
Debt ratio (%)	22.2	19.8
Durability of financing structure (%)	86.5	87.1

The decrease, versus 2012, in profit caused a deterioration of the ratios ROA (from 17.3% to 10.5%) and ROE (from 22.2% to 13.1%).

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In 2013, the Company maintained a level of liquidity which was similar to that of the prior year, despite incurring expenditures on property, plant and equipment in the amount of PLN 2 357 million and payment of a shareholder dividend of PLN 1 960 million.

The decrease in the debt ratio from 22.2% to 19.8% was mainly due to a lower level of liabilities due to derivative financial instruments (PLN (230) million) and to provisions for other liabilities (PLN (200) million). As at 31 December 2013, the level of liabilities due to bank loans amounted to PLN 1 123 million, meaning a decrease versus the prior year by PLN 110 million.

## **2. Realisation of Company Strategy and mission**

In 2013, KGHM Polska Miedź S.A. continued realisation of its approved Strategy of development for the years 2009-2018. In accordance with its strategic assumptions, the Company continued to advance development-related investments aimed at:

- activities to secure access to the resource base,
- projects in the energy sector, mainly in the power generation segment.

With respect to improving productivity, initiatives at a scale of significance for the Company are underway aimed at implementing the newest, environmentally-friendly and low-emission technology, which is applied in the global mining and metallurgical sector. Key strategic investments in this area are concentrated on the following:

- **research and technical-economic evaluation of the possibilities of implementing mechanical mining in the conditions prevalent in the mines of KGHM Polska Miedź S.A.** Mining through the use of combines is a technology which could replace the currently-applied method of mining by the Company's divisions using blasting. The main projects in this regard are:
  - o „Development and implementation in the conditions prevalent in the mines of KGHM Polska Miedź S.A. of technology for the mechanical mining of the deposit”. In 2013, in mining conditions, in a prepared pilot section in the Polkowice-Sieroszowice mine, tests began using the ACT mining complex. Positive results of these tests will form the basis for taking a decision as to the implementation of this mechanical deposit mining technology on a Company-wide scale.
  - o „Drilling of drifts using combines”. In 2013, work was completed related to preparing the organisational and technical infrastructure of a mining section in the ZG Polkowice-Sieroszowice mine and production tests were commenced using a team of three combines. Given the watershed nature of this project in developing the copper mines of KGHM Polska Miedź S.A., the drilling of drifts is being conducted in a so-called TW 357 combine group as part of the work to access the Deep Głogów area in the Polkowice-Sieroszowice mine.
- **construction of a technologically integrated, cost effective and environmentally friendly metallurgical structure for KGHM Polska Miedź S.A. through realisation of the comprehensive Pyrometallurgy Modernisation Program at the Głogów smelter.** With respect to the construction of a flash furnace complex at the HM Głogów I smelter, work began on construction of the main elements of the flash furnace production line, including the foundations and construction of the furnace hall. Work is continuing on contracting for equipment for individual parts of the flash furnace production line. In 2013, the first stage of modernisation of the main technological units of the flash furnace production line at the HM Głogów II smelter was realised, aimed at intensifying concentrate smelting. Work is underway on installation design, an important element of which is optimisation of smelting assets in terms of their best possible adaptation to the geological conditions of the deposits mined by KGHM Polska Miedź S.A.

With respect to activities to secure access to the resource base, the Company is realising initiatives aimed at:

- gaining new mining concessions to mine the deposits currently being worked,
- projects to develop the resource base in the region, i.e. south-west Poland and in Lusatia, a region in German Saxony,
- projects to develop the mining assets located outside of Poland.

Such an approach provides KGHM Polska Miedź S.A. with the opportunity to geographically diversify its core operations, and over the long term enables an increase in the production of copper and other metals at lower unit costs.

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In 2013, KGHM Polska Miedź S.A. received **new concessions for the extraction of copper ore from deposits currently being worked by the Company - „Polkowice”, „Sieroszowice”, „Lubin-Małomice”, „Rudna” and „Radwanice-Wschód” which are valid from January 2014 to December 2063.** Two agreements were simultaneously signed setting mining usufruct rights for „Lubin-Małomice” and „Sieroszowice”. On 31 December 2013, the District Mining Office approved the mine operating plans for the mines: Polkowice-Sieroszowice, Rudna and Lubin. Consequently, since 1 January 2014 the Company has continued its basic operations based on the new concessions, new mining usufruct agreements and new operating plans.

With respect to developing the resource base in the region, the following projects are being continued:

- Accessing the concession area **„Głogów Głęboki - Przemysłowy” (Deep Głogów)** - on 11 December 2013 the sinking of the GG – 1 shaft began as the first bucket of rock was extracted from shaft and work continued on realising temporary and permanent facilities at the shaft site. Work continued on developing primary drifts along with development of technical infrastructure. Concept and design work began related to the construction of a Surface-based Cooling Station at the R-XI shaft using so-called highly associated „tri-generation” units.
- Exploration and documentation of deposits within the exploration concessions held for the following areas:
  - o **Gaworzyce – Radwanice** – in August 2013 the Minister of the Environment issued a decision for the Company altering the concessions held, while work continued to determine the possibilities of mining the copper ore deposits in these areas. Conclusion of this work is planned to the end of 2014. Realisation of design work will enable prolongation of mining by the ZG Polkowice-Sieroszowice mine.
  - o **Retków-Ścinawa and Głogów** - in 2013 the Ministry of the Environment granted KGHM Polska Miedź S.A. a concession for exploration and assessment of the copper ore deposits in these areas, which are directly adjacent to the areas currently being mined by the Company. Commencement of exploratory work in these areas is planned in 2014.
  - o **Synklina Grodziecka** (located within the so-called Old Copper Belt near Bolesławiec) - in the second quarter of 2013 the Company commenced the second stage of exploratory work comprising 9 drillholes. In 2013 4 drillholes were completed. Drilling of a further 5 drillholes is planned for 2014.
  - o **Konrad** - in January 2014 the Company received a concession for exploration and assessment of the copper ore deposit in this area, located directly adjacent to the Synklina Grodziecka concession (the mining area of the old Konrad mine). Work on this area is enabling a comprehensive assessment of hydrogeological conditions for the project of de-watering the deposit and determining geological-mining conditions for future mining.
  - o **Bytom Odrzański and Kulów – Luboszyce** - With respect to requests submitted in 2012 by KGHM Polska Miedź S.A. for the granting of concessions for the exploration and assessment of these areas, January 2014 the Minister of the Environment issued decisions declining to grant a concession for the exploration and assessment of the Bytom Odrzański copper ore deposit and granting a concession for the exploration of the Kulów-Luboszyce copper ore deposit, in that part covered by the Company's request. These decisions are not legally binding, and KGHM Polska Miedź S.A. has submitted appeals of them to the Minister of the Environment.
  - o **Weisswasser** (Germany) - in the third quarter of 2013 the Saxon Mining Office (SOBA) issued a decision in which it prolonged the existing concession for this area to the end of 2016, and subsequently approved the plan for geophysical exploration in the area of Weisswasser II. In 2014 work will be conducted related to seismic and geophysical measurements.
  - o **Stojanów** - In July 2013, KGHM Polska Miedź S.A. submitted a request to the Minister of the Environment for the exploration and assessment of this copper ore deposit. In geological terms the area for which the concession is being sought is an extension of the Weisswasser II area into Poland. The Company expects that concessions will be granted for this area as part of the administrative proceedings currently in progress.
- In the third quarter of 2013, KGHM Polska Miedź S.A. submitted a request for the granting of concessions for the exploration and assessment of **a potassium-magnesium salt deposit with associated minerals, i.e. copper ore and rock salt, in the Zatoka Pucka region.** Due to the existing competition between the Company and third parties for the concessioned area, administrative proceedings are currently in progress regarding the granting of

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concessions. In August 2013, KGHM Polska Miedź S.A. signed a letter of intent with the company Gdańskie Zakłady Nawozów Fosforowych FOSFORY Sp. z o.o. regarding future cooperation in the case that concessions are granted, and the subsequent commencement of mining of the potassium-magnesium salt deposit. Subsequent to the aforementioned letter of intent, in January 2014 the Company signed an Agreement with Gdańskie Zakłady Nawozów Fosforowych FOSFORY Sp. z o.o. and the company Grupa Azoty Zakłady Azotowe „Puławy” S.A. regarding assumptions for cooperation with respect to exploration for, evaluation and extraction of deposits of potassium salts, phosphorus, rock salt and nonferrous metals.

- On 16 January 2014, KGHM Polska Miedź S.A. signed a letter of intent with the company **Grupa Azoty S.A.** with its registered head office in Tarnów, setting forth the general principles for the eventual undertaking of joint business activities in the following areas: processing of phosphogypsum, exploration for potassium salt deposits abroad, gaining access to sources of natural gas, construction of a polygeneration power plant, and exploration for and extraction of phosphorite. The Parties decided that any eventual realisation of joint projects in specific areas would be realised based on detailed agreements or through the creation of joint venture companies.

With respect to the acquisition and development of mining assets outside Poland, in 2013 KGHM Polska Miedź S.A. continued mining projects, realised through KGHM INTERNATIONAL LTD. which arose in 2012 as a result of the acquisition by KGHM Polska Miedź S.A. of the Canadian company Quadra FNX Ltd.:

- **The Sierra Gorda Project in Chile** (KGHM INTERNATIONAL LTD. 55%, Sumitomo Metal Mining and Sumitomo Corporation 45%) – during the first stage of the project work continued on construction of the mine. Realisation of the project is on time, with 85.58% completed at the end of 2013. Commencement of extraction is planned in mid-2014.
- **The Victoria mine project in the Sudbury Basin of Canada** (KGHM INTERNATIONAL LTD. 100%) - In 2013 as part of realisation of the project work continued on the mine plan and documentation necessary to submit a request for a building permit was developed and completed. At the end of 2013 work began on levelling the terrain to prepare for construction of the future mine aboveground infrastructure. The project foresees the construction of an underground mine enabling the extraction of a polymetallic ore rich in copper, nickel and precious metals (mainly platinum and gold).

On 1 August 2013, a framework agreement was signed by KGHM INTERNATIONAL LTD. and FNX Mining Company Inc., with Vale Canada Limited (a subsidiary of Vale S.A.), describing the conditions for realisation by KGHM INTERNATIONAL LTD. of the Victoria project – the mining of a deposit of copper, nickel and metals of the platinum group. Vale will purchase polymetallic ore from KGHM INTERNATIONAL LTD. and will process it in its Clarabelle plant in Sudbury, owned by Vale. KGHM INTERNATIONAL LTD. remains the 100% owner of the Victoria project, while Vale will receive a Net Smelter Return royalty on all future production from the project in the amount of 2.25%.

- **Afton-Ajax project in British Columbia in Canada** (KGHM Polska Miedź S.A. 80%, Abacus Mining and Exploration Corp. 20%) – the project is at the stage of acquiring required environmental and mining permits. Independently of this, engineering work is being continued on preparations for construction of the mine. In 2013, a variety of geological work was performed across the project area, which indicated significant potential for copper mineralisation. In 2014, additional geological work is planned, including an additional campaign of exploratory drilling and geophysical research. The decision was simultaneously taken to prepare an alternative mine plan, one which will both maximise the value of the Afton-Ajax project as well as reduce its impact on the environment.

With respect to increasing energy production, projects were continued whose realisation will ensure a portion of the energy needs of KGHM Polska Miedź S.A. and will lead to diversification of the energy generation portfolio and significantly reduce the Company's exposure to climate policy risk, and to changes in fuel and electricity prices.

- **„Construction of gas-steam blocks at the Głogów and Polkowice power plants”** - In 2013, final acceptance procedures were conducted and start-up tests of the gas-steam blocks were performed. On 5 November 2013, the gas-steam block in Polkowice was handed over for operation. Handover of the the gas-steam block in Głogów will take place in the second quarter of 2014. The project will enable the optimisation of power and heating costs in KGHM Polska Miedź S.A. through the associated production of energy using internal generation capacity at the level of 560 000 MWh, all of which is designated to meet the power needs of the Company.

- **„Construction of a research installation for the underground gasification of brown coal in the Legnica-Głogów Copper Belt”.** In 2013, as part of the program of geological work for exploration of the brown coal deposit in the Głogów region, in a selected area located in the Legnica-Głogów Copper Belt, holes were drilled and specialised geological research was performed aimed at exploring and evaluating the brown coal resources. Positive results from this geological work will enable a decision to be taken on whether to apply for a concession for mining of this deposit using an underground brown coal gasification research installation.

In 2013, KGHM Polska Miedź S.A., to ensure supplies of energy and to improve pricing conditions, searched for possibilities of involving the Company in projects to create new sources of supplies of energy and fuels in Poland. Following are examples of such projects:

- Construction of a power generation source based on the utilisation of natural gas as the raw material for its generation, on the grounds of the existing Blachownia Power Plant,
- Exploration for and extraction of shale gas in Poland (KCT Project),
- Preparation for the construction and operation of the first Polish nuclear power plant.

Taking into consideration the achievements to date in realisation of the approved Strategy of KGHM Polska Miedź S.A., mobilisation of the internal resource potential, as well as the macroeconomic conditions facing the global mining sector, in the years 2012-2013 the Company commenced work on a broad strategic analysis of the potential for the further development and building of the value of the KGHM Polska Miedź S.A. Group. The conclusions reached following this analysis will form the basis for determining the foundations for building a new Company vision and for preparation of the draft updated Strategy of the KGHM Polska Miedź S.A. Group.

Until the new strategic directions of KGHM Polska Miedź S.A. are defined, for which there exist sufficient causes to do so, the Company's strategic priorities will be concentrated on:

- commencing production at the Sierra Gorda project in Chile,
- building skills and relations in terms of new commodities,
- ensuring high, stable cash flow,
- creating a global organisation,
- further improvement in skills,
- continuing the path of growth.

### **3. Assessment of the financial risk management system in the Company in 2013**

In 2013, KGHM Polska Miedź S.A. completed design work aimed at implementing a comprehensive integrated risk management system, supporting the management process at the strategic and operational level for the KGHM Polska Miedź S.A. Group.

This project was an element in realisation of the Strategy, as well as in developing skills and organisational efficiency, improving corporate governance and strengthening investor trust in the Company. The efficient implementation of such a system strengthens the robustness of the Company, its predictability and stability, and its responsibility towards its shareholders, as well as its ability to adapt to the volatile conditions of the business environment.

An integral part of the project was the conduct of a program of training for management staff and employees of the KGHM Polska Miedź S.A. Group in the question of risk management at the basic level (comprising principles and the adopted risk management model) [realised at the turn of 2012/13] and at the advanced level (dedicated workshops for selected groups of participants/roles in the risk management process) [realised in 2013].

As a result of realisation of this project, in November 2013 the following documents were approved:

- **The Corporate Risk Management Policy in the KGHM Polska Miedź S.A. Group, describing the method of approach, setting forth basic principles and establishing the corporate risk management process in the KGHM Polska Miedź S.A. Group.**



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This comprehensive approach to risk management conforms to the strategy of growth, with consistent efforts at operational improvement and with the principles of balanced growth and corporate responsibility. It was designed so as to support the Company in building a robust corporate structure.

The goals of risk management are to:

- ensure the creation and protection of shareholder value by establishing a unified approach to the identification, assessment, risk analysis and implementation of answers to key risks;
  - protect the lives and health of employees, the natural environment and the brand's reputation;
  - support the achievement of business goals through implementation of the tool of early recognition of opportunities and threats;
  - ensure strong support in making decisions at all levels of the organisation; and
  - build an organisation aware of the risks it takes and determined to continually improve.
- **The Corporate Risk Management Procedure in KGHM Polska Miedź S.A., describing the sequence of individual stages, the role and responsibilities of individual participants and the applicable timeframes for the corporate risk management process in the KGHM Polska Miedź S.A. Group.**

The goal of the Procedure is to ensure that key risks are identified, assessed and analysed, and on the basis of these assessments appropriate Risk Response Plans are prepared and Corrective Actions are implemented which provide for the limitation of threats and realisation of assumed business goals and will support identification of opportunities to build competitive advantage.

This Procedure was developed in accordance with best practices and was adapted to the needs and specifications of the KGHM Polska Miedź S.A. Group. It is inspired by solutions adopted by the standard ISO 31000:2012, which were adapted to the organisational conditions and cultures of the KGHM Polska Miedź S.A. Group. In addition, it implements selected practices developed in other norms and standards such as COSO I and II.

- **The Corporate Risk Committee Rules of KGHM Polska Miedź S.A., containing the Committee's functional principles, enabling the Committee to realise the corporate risk management process, in accordance with principles set forth in the Policy and Procedure.**
- **The Corporate Risk Management Methodology of KGHM Polska Miedź S.A., describing ways to proceed and supporting tools in performing specific tasks arising from the Procedures, comprising among others Risk Models, Risk Assessment Matrices, Risk Registration, Risk Cards, Detailed Risk Cards, Risk Maps etc.**

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 realisation of the business goals. The current, future, actual and potential impact of risk on the achievement of business goals is assessed. Based on this assessment, management practices are reviewed and adjusted in terms of responses to individual risks.

In 2013, as part of the design work realised, the process of identification and assessment of risk in KGHM Polska Miedź S.A. was performed. Based on the process of identification and risk assessment, reflecting their position on the Risk Map, key risks were selected for KGHM Polska Miedź S.A. These risks will be the subject of deeper analysis in order to develop a Risk Response Plan and Corrective Actions. Other risks will be continuously monitored by the Corporate Risk Management and Conformity Department.

The management of individual risks (including among others market risk) is the subject of separate individual regulations in KGHM Polska Miedź S.A. and is covered by the following documents:

- „Market risk management principles”, comprising among others: Market Risk Management Policy and the Rules of the Risk Management Committee.
- „Credit Risk Management Policy and the Rules of the Credit Risk Committee”.
- „Financial Liquidity Management Policy”.

### **3.1 Assessment of the financial risk management system in the Company in 2013**

In 2013, the Company was exposed to the main financial risks i.e. market risks, credit risk and liquidity risk.

The goal of financial 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. Financial risk management 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.

### **3.2 Market risk management**

The Management Board is responsible for market risk management in the Company and for adherence to policy in this regard. The main body involved in realising market risk management is the Market Risk Committee, which makes recommendations to the Management Board in this area. The primary technique for market risk management is the use of hedging strategies involving derivatives. Apart from this, natural hedging is also used.

#### Commodity risk, Currency risk

In its activities the Company is mainly exposed to the risk of changes in the price of metals it sells: copper and silver. In addition, of major significance for KGHM Polska Miedź S.A. is the risk of changes in currency rates, in particular the USD/PLN exchange rate.

The Company continuously analyses the metals and currency markets, and these monitoring activities are the basis for taking decisions on implementing hedging strategies. The management of market risk is also determined by the internal situation of the Company. KGHM Polska Miedź S.A. applies future cash flow hedge accounting. Monitoring of the amount of market risk in the Company is based on analysis of the impact of market risk factors on the activities of the Company (profit, statement of financial position, statement of cash flows) among others using the market risk measure Earnings-at-Risk, based on Corporate Metrics methodology.

In 2013, no copper and silver price hedging strategies were implemented. However, in the second quarter of 2013 there was a restructuring of a hedging position on the silver market by closure of the hedging position on silver market, which guaranteed the Company increased revenues from sales in the second half of 2013 by PLN 95 million. In the case of the forward currency market, in 2013 the Company implemented transactions hedging revenues from sales with a total nominal amount of USD 480 million and a time horizon falling in the years 2014-2015. The effective exchange rate was USD/PLN 3.14 for 2014 and 3.23 for 2015.

In 2013, the result on derivatives in the Company was PLN 73 million of which:

- PLN 450 million was transferred to revenues from sales,
- PLN 377 million decreased other operating activities (wherein: the loss from realisation of derivatives amounted to PLN 185 million, and the loss from the measurement of derivatives amounted to PLN 192 million).

The loss from the measurement of derivatives transactions, recognised in other operating activities, is mainly due to changes in the time value of options, which in accordance with hedge accounting policy is recognised in profit or loss.

As at 31 December 2013, the fair value of open positions in derivatives (on the copper and currency markets) amounted to PLN 791 million, while PLN 617 million was recognised in the revaluation reserve from the measurement of derivatives.

#### Interest rate risk

Interest rate risk is the danger of the negative impact of changes in interest rates on the Company's results. In 2013 the Company was exposed to this risk due to loans granted, unallocated cash placed on deposits, participating in zero-balance cash-pool services and borrowing.

The impact of changes in interest rates on the Company's results, due to financial receivables held and financial liabilities drawn, is estimated as immaterial, due to the scale of the Company's operations. In 2013, the Company did not make use of interest rate risk hedging instruments.

### **3.3 Financial liquidity management**

Capital management is aimed at maintaining continuous financial liquidity in each period. The Company actively manages the liquidity risk to which it is exposed. This risk is understood as the ability to pay financial liabilities on time and to gain resources to finance its activities.

The Company manages its financial liquidity in accordance with the „Financial Liquidity Management Policy” adopted by the Management Board. This document describes in a comprehensive manner the process of managing financial liquidity in the Company, based on best practice for such procedures and instruments.

The basic principles resulting from this document are:

- the investment of financial surpluses in safe instruments,
- limits for individual financial investment categories,
- concentration limits on monetary resources for financial institutions,
- assuring the appropriate financial sources.

In 2013, the Company engaged in borrowing in the form of bank loans, both working capital facilities and overdraft facilities.

As at 31 December 2013, the Company held borrowing liabilities in the amount of PLN 1 123 million (i.e. USD 373 million) and open lines of credit in PLN, USD and EUR.

Also, in order to maintain financial liquidity and the creditworthiness to acquire external financing at a reasonable cost, the Company monitors its capital, among others based on the equity ratio and the net debt/EBITDA ratio.

The Company assumes that the equity ratio shall be maintained at a level of not less than 0.5, and the ratio of net debt/EBITDA at a level of up to 2.0.

The Company continues to add additional companies to the cash management service of the KGHM Polska Miedź S.A. Group (zero-balance cash pool). The funds available under this service bear an interest rate based on variable WIBOR. The credit limit available in the account as at 31 December 2013 was PLN 431 million.

This service enables optimisation of costs and effective management of current cash liquidity in the KGHM Polska Miedź S.A. Group.

### **3.4 Credit risk management**

Credit risk is defined as the risk that counterparties of the Company will not be able to meet their contractual obligations.

In 2013, KGHM Polska Miedź S.A. was exposed to this risk, mainly in four areas, related to:

- trade receivables,
- cash and cash equivalents and bank deposits,
- loans granted, and
- derivatives transactions.

The Management Board is responsible for managing credit risk in the Company and for adhering to policy in this regard. The main body involved in realising activities in this respect is the Credit Risk Committee.

#### Credit risk related to trade receivables

The Company limits its exposure to credit risk related to trade and other receivables by evaluating and monitoring the financial condition of its customers, setting credit limits and using debtor security. An inseparable element of the credit risk management process realised by the Company is the on-going monitoring of receivables and the internal reporting system. Buyer's credit is only provided to proven, long-term customers, while sales of products to new customers are mostly based on prepayments. In 2013 the Company secured the majority of its receivables by promissory notes, frozen funds on bank accounts, registered pledges, bank guarantees, corporate guarantees, mortgages and documentary collection. Additionally, the majority of customers who hold buyer's credit on contracts have ownership rights confirmed by a date certain.

To reduce the risk of insolvency by its customers, the Company has entered into a receivables insurance contract, which covers receivables from entities with buyer's credit which have not provided

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strong collateral or have provided collateral which does not cover the total amount of the receivables. Taking into account the collateral held and the credit limits received from the insurance company, as at 31 December 2013 the Company had secured 74% of its trade receivables.

The concentration of credit risk in the Company results from the fact that key clients are allowed extended terms of payment. Consequently, as at 31 December 2013 the balance of receivables from 7 of the Company's largest clients, in terms of trade receivables at the end of the reporting period, represented 64% of the trade receivables balance (as at 31 December 2012: 66%). Despite the concentration of this type of risk, the Company believes that due to the availability of historical data and the many years of experience cooperating with its clients, as well as to the hedging used, the level of credit risk is low.

**Credit risk related to cash and cash equivalents and bank deposits**

The Company deposits periodically unallocated cash in accordance with the requirements to maintain financial liquidity and limit risk and in order to protect capital and maximise interest income.

Credit risk related to bank deposits is continuously monitored by an ongoing review of financial position and by maintaining an appropriately low level of concentration in individual financial institutions.

**Credit risk related to derivative transactions**

All of the entities with which the Company enters derivative transactions operate in the financial sector. These are mainly financial institutions, with the higher and medium-high ratings. According to fair value at 31 December 2013, the maximum share of a single entity with respect to credit risk arising from open derivative transactions entered into by the Company and from unsettled derivatives amounted to 22%. Due to diversification of risk in terms both of the nature of individual entities and of their geographical location, as well as taking into consideration the fair value of assets and liabilities arising from derivative transactions, the Company is not materially exposed to credit risk as a result of derivative transactions entered into.

#### **4. 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.

The combined departments systematically evaluate and monitor the control mechanisms and identify potential risks in individual processes occurring in the Company and in the entire Group, as well as uncover 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. based on the principle of independence, and may encompass virtually all areas of the Company's and Group's operations.

In 2013, the Department of Internal Auditing and Internal Control performed 11 planned and 5 ad hoc tasks, as well as 12 planned controls and 9 controls of an ad hoc nature. 2 planned controls not performed in 2012 were also completed. Three audits were performed with the assistance of an external firm. Controls and audits were performed both in the divisions as well as in companies of the KGHM Polska Miedź Group.

As a result of audits performed in 2013 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 regulations, 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.

## **5. Selected areas requiring attention**

### **5.1 Securing external financing for the investment program**

Taking into consideration the high degree of progress in the realisation of strategic development and sustaining projects, it is necessary to maintain a proper financing structure for the KGHM Group. In particular, due to the long term nature and scale of the investments in progress, as well as the market risk to which the Company is exposed, the highest priority is to secure stable medium and long term external financing.

### **5.2 Investment in Sierra Gorda**

In 2013, a definitive cost estimate was made for the Sierra Gorda project. Total capital expenditure to commence the project amounts to over USD 4 billion versus USD 2.9 billion forecast in February 2011. The main factors responsible for increasing expenditure are beyond the investor's control: rising costs of labour, services and materials in mining in Chile, inflation, appreciation of the peso, altered legal requirements regarding construction and environmental protection and changes in the project's scope. The amount of the updated capital expenditure does not include potential savings, including hedge policy applied and the possibility of implementing a program of leasing mining equipment for the project.

The first stage of the Sierra Gorda project is at an advanced stage of realisation of construction and assembly work. Realisation of the project is on time, with 86% completed at the end of 2013. As part of the first stage of investment, with respect to construction of the mine's technical infrastructure, major work was completed related to construction of basic infrastructure, including social buildings and fresh water supplies, design work was completed as well as construction of the 220kV and 110kV power networks together with primary and sub-stations. With respect to construction of the mine's production-related facilities, work continued on assembling the installations, machinery and equipment of the production line. In addition, work continued on stripping of the overburden (including oxide ore) needed to access the actual ore deposit. By the end of December 2013, 158.8 million tonnes of rock had been removed, i.e. around 81% of the target amount.

The oxide ore is at present being stored in separate heaps, and tests are being performed on its processing potential. Design work was performed aimed at preparing assumptions for starting up the metals recovery installation using SX/EW technology.

The Sierra Gorda project is financed from three sources – by the investors (KGHM INTERNATIONAL LTD. and Sumitomo Group companies) and from borrowing. A bank loan in the amount of USD 1 000 million was granted for a period of 9.5 years by a consortium of financial institutions: Japan Bank for International Cooperation and by the four private banks Mizuho Corporate Bank, Ltd., Sumitomo Mitsui Banking Corporation, The Bank of Tokyo Mitsubishi UFJ, Ltd. and The Sumitomo Trust & Banking Co., Ltd. This is a project finance loan without recourse to KGHM INTERNATIONAL LTD.

Planned, target average annual production is 220 kt of copper, 11 kt of molybdenum and 2 tonnes of gold. Mine operating life is over 20 years. Commencement of extraction at Sierra Gorda is planned in mid-2014.

### **5.3 Pyrometallurgy Modernisation**

As part of the realisation of the Pyrometallurgy Modernisation II Project, in 2013 construction-assembly work was completed on Stage I installations (the Flash Furnace Collector, the Recovery Boiler, the Electric Furnace and the Power Switching Station). In 2014 stage II of the modernisation is planned (Scrubber, Sulphuric Acid Warehouse, and 110/6kV GSTII Power Station).

With respect to ongoing installation design work, an important element of which is the optimisation of smelting assets in terms of their optimal adaptation to the geological conditions of the deposit being mined by KGHM Polska Miedź S.A., work continues on a means to eliminate or separate organic carbon from the concentrate produced by KGHM Polska Miedź S.A. Solution of this question will enable further cost and technical optimisation of smelter production.

### **5.4 Głogów Głęboki Przemysłowy (Deep Głogów) Project**

The goal of the Project is to create conditions to maintain profitable and stable mine production in KGHM Polska Miedź S.A. to the year 2030.

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In January 2014 required work was completed to commence production from the Deep Głogów area.

Work is in progress on redefining the entire Program based on long terms production plans so as to enable access to the deposit and maintain profitable production to the year 2055.

**5.5 The Comprehensive Risk Management System in the KGHM Polska Miedź S.A. Group**

In 2014, work will continue on developing the Risk Management System in the KGHM Polska Miedź S.A. Group, comprising among others:

- conducting in-depth analyses of key risks to develop a Risk Response Plan and Corrective Actions;
- continued implementation of the process of risk management in individual Group companies, realised in conformance with the documentation for this process approved at the level of Group companies.

In addition, in 2014, KGHM Polska Miedź S.A. commenced work aimed at implementing a compliance system, comprising implementation of a system for managing compliance with internal Company regulations, the Company's regulatory environment, best market practices adopted by the Company and good habits and customs related to the Company's market operations, which are a natural extension of the corporate risk management system.

**5.6 Auditor concerns and recommendations**

The Supervisory Board acknowledged, supplemented by the position of the Management Board, the Auditor's Letter directed to the Management Board and Supervisory Board, regarding important questions identified during the audit for the financial year ended 31 December 2013. In this document the Auditor expressed its concerns and recommendations regarding strengthening of the system of internal control and improved operational effectiveness, in particular regarding: evaluation of impairment to assets value and strengthening of the control function with respect to the functioning of the special purpose companies created for the purpose of acquiring KGHM INTERNATIONAL and of Group accounting. The Supervisory Board recommends implementation of the recommendations included in the Auditor's Letter.