

**NR. 13232/16.05.2016-engleza**

**SUBSTANTIATION NOTE  
ON  
THE 2016 INCOME AND EXPENDITURE BUDGET**

**I. The substantiation** of the 2016 Income and Expenditure Budget and of the 2017 - 2018 forecast was based on the law concerning:

*~ implementation of International Financial Reporting Standards by the companies whose securities are traded on a regulated market;*

*~ strengthening of the financial discipline and establishing the expenses for salaries and wages in the 2016 budget, at the level of economic operators where the state or administrative territorial units are sole or majority shareholders or hold directly or indirectly a majority participation;*

*~ profit allocation by the national companies and trade companies fully or majority state owned, as amended;*

*~ implementation of the Fiscal Code provisions;*

*~ ANRE Decision no. 446/23.03.2016 concerning the delay of the implementation period until 1<sup>st</sup> of April 2017 of Article 3 of ANRE Decision no. 2588/30.12.2015 on changing the titleholder of licence no. 1942 for operation of underground natural gas storage system from SNGN ROMGAZ S.A. MEDIAS to SNGN ROMGAZ S.A. FILLALA DE INMAGAZINARE GAZE NATURALE DEPOGAZ PLOIESTI S.R.L.*

*~ layout and structure of the income and expenditure budget, as well as its related substantiation annexes;*

**II. The assumptions of preparation** of income and expenditure budget based on „The Forecast of the Main Macroeconomic Indicators For the Period 2015 – 2019” as published by the National Prognosis Commission, Winter Prognosis –February 2016.

	<i>Year 2016</i>	<i>Year 2017</i>	<i>Year 2018</i>
Index of consumer price increase %			
- year end	1.8	2.5	2.3
- annual average	0.0	2.3	2.5
Estimated exchange rate RON/USD	3.93	3.88	3.83
Estimated exchange rate RON/EUR	4.44	4.42	4.40

### III. Outline and Substantiation of the Indicators Included in Romgaz 2016 Income and Expenditure Budget

#### 1. SUBSTANTIATION OF INCOME

The substantiation of the main income categories of the income and expenditure budget is based on the forecasted evolutions of the gas demand and delivery price, the production programs, gas storage in underground facilities, program of the import gas acquisition and delivery program.

Revenues of the Electricity Production Branch (Sucursala de Producție Energie Electrică Iernut (SPEE Iernut)) are generated from the electricity production and delivery as well as from other field related services.

Besides the main revenue categories, revenue is also recorded from other activities such as: service provision for third parties (transmission, gas dehydration and compression, rental of goods, chemical analyses, sale of condensate, sale of goods).

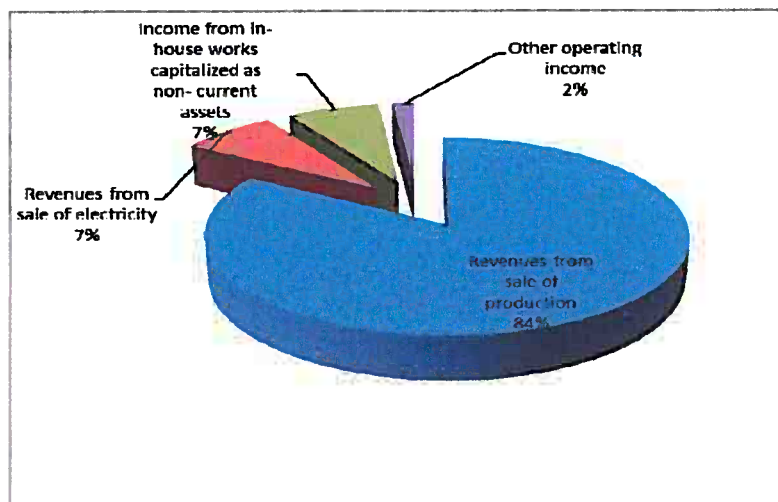
#### **Operating Income**

After analysing the market's offer (total production+import) and demand (consumption potential+storage) the finding indicates for 2016 Q2 and Q3 an oversupply of natural gas. Under these circumstances we estimate a reduction of internal gas volumes and implicitly of revenue generated by such sales.

Operating income in amount of **RON 3,778,637 thousand** is estimated to be by 15.7% below the 2015 results. Operating income includes income from:

- ~ sale of gas production;
- ~ sale of condensate;
- ~ revenues from gas storage services;
- ~ sale of electricity;
- ~ sale of goods;
- ~ income from in-house works capitalized as non-current assets;
- ~ other income from fines and penalties, sale of assets.

The structure of operating income for 2016 is shown in the figure below:



Operating income is detailed in the table below:

Item no.	Description	2015 Result - RON thousand -	2016 Budget proposal - RON thousand -	Ratios 2016 Budget / 2015 Result - % -
1	Revenues from Romgaz gas sales delivered from own production (excluding joint ventures, and gas for electricity production)	3,159,884	2,626,101	83.11%
2	Revenues from joint ventures	131,373	119,569	91.01%
3	Revenues from import gas deliveries	4,169	11,205	268.77%
4	Revenues from electricity deliveries	334,411	283,547	84.79%
5	Revenues from storage services	332,526	378,502	113.83%
6	Revenues from sale of production (including goods and changes in inventories)	228,501	22,843	10.00%
7	Income from in-house works capitalized as non-current assets	214,267	272,459	127.16%
8	Other operating income	80,745	64,411	79.77%
	<b>Total operating income</b>	<b>4,485,877</b>	<b>3,778,637</b>	<b>84.23%</b>

*Revenues from Romgaz gas delivered from own production (excluding gas from joint ventures and gas for electricity production) were determined based on the gas quantities estimated to be delivered to clients in 2016 and on the average delivery price of gas from current production and withdrawn from UGSs for both household and non-household consumption.*

*Revenues from joint ventures represent the value of natural gas delivered under joint-ventures and which correspond to Romgaz participating interest.*

*Revenues from import gas deliveries represent the value of natural gas purchased from import and resold by Romgaz to own clients.*

*Revenues from delivered electricity were determined based on the quantities of delivered electricity and the estimated average delivery price.*

*Revenues from underground gas storage services were determined based on services supplied for gas injection and withdrawal into/from UGSs and for capacity reservation.*

*Revenues from sold production (including goods and changes in inventory):*

- ~ revenues from **natural gas distribution** (regulated activity) related to distribution of natural gas from Piscu-Stejari and Ghercești;
- ~ revenues from **delivery of condensate**, related to deliveries of condensate resulting from natural gas production;
- ~ revenues from **rentals**, related to renting of spaces and/or fixed assets to third parties;

- ~ revenues from selling of *commodity gas* are revenues from reselling of gas purchased from third parties (gas producers) who do not have the necessary infrastructure to deliver them in the National Transmission System;
- ~ revenues from *other supplied services* represent the revenues generated by the equivalent value of services supplied by the branches to third parties (gas compression, gas dehydration services).
- ~ income from *changes in inventories* representing the difference between the quantity of own gas injected in the underground storage (+) and the one withdrawn (-) from the underground storage quantified to the actual withdrawal cost.

*Income from in-house works capitalized as non-current assets* represents the value of works performed in-house included in non-current assets.

For *Other operating income* 86.2% consist of penalties to clients for delayed payment of equivalent value of delivered gas.

**Financial income** in amount of **RON 32,106 thousand** is 99% generated by the interests received from banks for the company's cash placed in bank deposits and state bonds. This income is anticipated to be below the previous year's income as a result of decreasing bank interests.

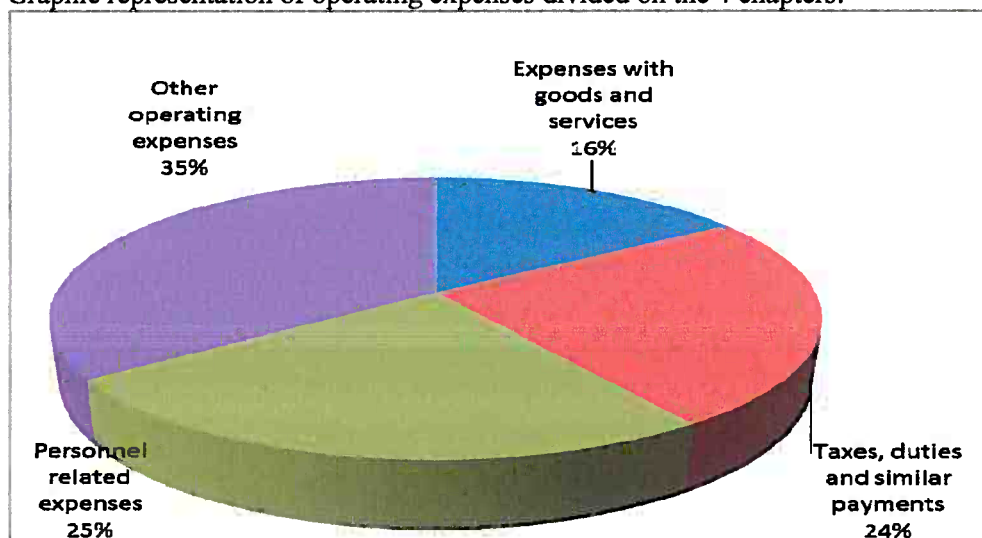
## 2. SUBSTANTIATION OF EXPENDITURE

*Operating expenses* are classified in 4 main chapters, as follows:

- A. Expenses with goods and services;
- B. Expenses with taxes, duties and similar payments;
- C. Personnel related expenses;
- D. Other operating expenses.

RON thousand	Results 2015	Budget 2016	Ratio (%)
	1	2	3=2/1
<b>A. Expenses with goods and services, out of which:</b>	<b>379,178</b>	<b>405,412</b>	<b>106.92%</b>
A1.Expenses with inventories	252,121	262,912	104.28%
A2.Expenses with services supplied by third parties	26,271	31,618	120.36%
A3.Expenses with other services supplied by third parties	100,786	110,882	110.02%
<b>B Expenses with taxes, duties and similar payments</b>	<b>786,821</b>	<b>617,124</b>	<b>78.43%</b>
<b>C. Personnel related expenses</b>	<b>602,196</b>	<b>638,335</b>	<b>106.00%</b>
<b>D. Other operating expenses</b>	<b>1,263,596</b>	<b>881,263</b>	<b>69.74%</b>
<b>Total Operating Expenses</b>	<b>3,031,792</b>	<b>2,540,133</b>	<b>83.85%</b>

Graphic representation of operating expenses divided on the 4 chapters:



#### **A. Expenses for Goods and Services:**

For this expense category (A) of RON 405,412 thousand, an increase of 6.92% is forecasted as compared to the 2015 estimate. This increase is mainly influenced by the high scheduled volume of in-house works relating to intangible assets and to maintenance works.

The attenuation of natural decline of the gross natural gas production incurs inventories-related expenses, each branch having specific consumption norms, depending on the branches' scope of activity. These expenses are forecasted to increase by 4.3% as compared to 2015, meaning RON 262,912 thousand.

A significant share in Expenses for Goods and Services is held by the value of pipes, tubing, wellheads, foaming agents, cement, spare parts for the maintenance of gas compressors and gas drying stations.

Expenses in connection with third party services will increase by 20.4% as compared to 2015 and the forecast is at a level required for ensuring the operation continuity under safety conditions. The highest share relates to the maintenance and repairs of equipment specific for the natural gas extraction activity. This category includes inspection and refurbishment works for buildings, construction, equipment, machinery, compressor manifold, and partial or total replacement of elements or part of elements of such equipment.

Expenses in connection with third party services consist of expenses in connection with partners, commissions, fees, legal services, protocol, advertisement and publicity, sponsorship, transportation, employee transportation and relocation, security, organization restructure design, employee training, etc. Experts for land register and topography services are co-opted. On January 26, 2015, the Extraordinary General Meeting of Shareholder (EGMS Resolution no. 1/January 26, 2015) approved the procurement of legal assistance services and of specialised legal assistance and representation services for the following issues:

- i. Dispute resulting from ANAF's completion of specific fiscal control;
- ii. Commencement of CTE Iernut development project at SPEE Iernut in form of "association in participation" as legal form of organization;
- iii. Commercial/civil/criminal disputes resulting from carrying out commercial activities.

## **B. Expenses for Taxes, Duties and Similar Payment:**

These expenses include royalty calculated as percentage from the physical production and condensate (RON 234,625 thousand), windfall profit tax (RON 248,545 thousand), construction tax according to Government Emergency Ordinance no.102/2013 in amount of RON 74,206 thousand, land and building taxes, total permitting, licencing and environment taxes (RON 59,248 thousand).

Please note that the determination of the gas quantity for royalty purposes is made in accordance with Petroleum Law no. 238/2004 (Chapter VI, Article 49) by applying a percentage to the gross production of the reservoir. The average royalty level of S.N.G.N. Romgaz S.A. is 7%.

## **C. Personnel-related Expenses :**

Personnel-related expenses were substantiated based on:

~**Government Ordinance no. 26/2013 on strengthening the financial discipline at the level of economic operator where the state or administrative territorial units are sole or majority shareholders or hold, directly or indirectly, a majority as amended and supplemented;**

~ **Law no. 227/2015-Fiscal Code;**

~ **Law no. 339/2015 of the State Budget for the year 2016;**

~ **Labour Code;**

~ **Collective Labour Agreement**

In accordance with the 2016 State Budget Law No 339/ 2015, Article 54, paragraph 1, item c), the economic operators applying OG 26/2013 may increase the employee benefit expenses as compared to the ones provided in the latest budget by the amount related to the increase of personnel forecasted for the end of 2016 as compared to the one approved in the previous year, correspondingly to the period between forecasted employment and end of the year.

The provision of Article 54, paragraph 1), item c) and paragraph 3) of the 2016 State Budget Law No 339/ 2015 were applied in substantiating the employee salary related expenses.

The company forecasted the employment of 46 persons (average 19) for the new investments to be commissioned during the budget period.

The employee salary related expenses increased by 3.24% as compared to the 2015 results 2015 mainly due to the increase of the average number of personnel (3.12%).

The average monthly income per employee determined on basis of salary expenses remained at the same level as in 2015.

The forecasted number of employees at the end of 2016 amounts to 6,411, with an average of 6,384.

The company included the amount of 400 EUR/employee in the contribution to optional pension plans, and "other contributions and special funds" included the amount of 400 EUR/employee representing health insurance, in compliance with the Fiscal Code and the Collective Labour Agreement.

The employer's contributions to social security rates are those provided in **LAW no. 227/2015 on the Fiscal Code.**

The expenses related to the mandate contract and other management and control bodies, commissions and committees have been estimated in accordance with the mandate contract and director agreements, respectively. In 2015, as well as in the 2015 income and expenditure budget, approved by Government Decision no. 936/2015, the costs with the variable component related to Q4 and the year 2015 are included in Provisions (and not in the employee benefit expenses) and are to be born in the year following the financial year for which these are granted, based on fulfilment of the performance criteria and objectives.

In 2016, the expense with the provision of the previous year is recorded in write back of provisions and the amount actually granted is a cost element related to mandate contracts and director agreements. Moreover, the variable components of the remunerations of the director general and the Board Members are calculated based on performance indicator fulfilment, where the calculation formulae of such indicators are included in the contracts.

Performance criteria calculation is made by comparing the results to the average of the result over the last three reporting periods.

A summary of weighting coefficients and performance criteria are shown in the table below:

Item no.	Specifications	Nature of indicator	Monetary units	Weighting coefficient	Performance criterion
1	<b>EBITDA</b>	maximizing	Thousand RON	<b>0.25</b>	<b>4.5%</b>
2	<b>Revenue</b>	maximizing	Thousand RON	<b>0.20</b>	<b>+6%</b>
3	<b>Labour productivity (W)</b>	maximizing	Thousand RON revenue/employee	<b>0.10</b>	<b>+6%</b>
4	<b>Operating expenses related to 1000 RON income from operations</b>	minimizing	RON	<b>0.10</b>	<b>-0.6%</b>
5	<b>Volume of geological resource</b>	maximizing	million m <sup>3</sup>	<b>0.10</b>	<b>+1%</b>
6	<b>Decline of natural gas production</b>	minimizing	%	<b>0.15</b>	<b>1.5%</b>
7	<b>Outstanding payments</b>	-	Thousand RON	<b>0.10</b>	<b>0</b>

#### **D. Other operating expenses:**

Estimated expenses for 2016 are lower by 30.26%, such reduction being generated mainly by the decrease of adjustments and provisions (by approx. 80%).

The chapter includes expenses with non-current assets, other expenses not included in the previous chapters, tangible and intangible assets amortization, adjustments and provisions.

#### **IV. 2016 Profit Distribution Proposal**

The recommendations of the Board of Directors according to Article 1 of Resolution No. 18/02.10.2013 of the Board of Directors are as follows: *“The Board of Directors estimates that by means of dividend policy, Romgaz may pay dividends up to maximum 75% from the company’s accounting profit after deduction of profit tax, estimating though, that starting in 2016 supplementary needs might appear to finance investment objectives”*. The same Article mentions that *“The Board of Directors considers that the majority shareholder should adopt a prudent policy when setting dividends.”*

Following the recommendations of the Board of Directors of January 28, 2016, the net profit distribution rate to shareholders was as high as 70% in 2016, and for the period 2017 – 2018 it was set to 50%.

**V. Level of Overdue Receivables** estimated for the end of 2016 amounts to RON 947,800 thousand.

**VI. Level of Arrears is estimated to RON 0 .**

**VII. Investment Program in amount of RON 1,020,000 thousand** is higher by 8.75% (by RON 82,083 thousand) than the 2015 results in amount of RON 937,916 thousand and it is completely self-financed.

The priority directions of ROMGAZ 2016 Investment Program are focused on projects aiming to compensate the natural decline of the natural gas production, by way of:

- Continuance of geological research works through new exploratory drillings and geological and geophysical surveys to discover new natural gas reserves;
- Development of the production potential by ensuring new capacities for the already existent facilities (drilling of exploration wells, compression units, booster compressors, modernization and refurbishment of the already existing units), improving the performances of the existing facilities and equipment, in order to increase the operational safety, reduce energy consumptions and enhance efficiency of gas reservoir production;
- Preserving the underground natural gas storage capacity, flexibility and security of operation for the already existent storages and building up new capacities;
- Modernization and refurbishment of special well operation and intervention equipment and installations, as well as acquisition of high performance equipment and installations specific for basic activity;
- Specific machinery acquisition to ensure technological transportation and maintenance of the base activity, as well as maintaining optimum conditions of road infrastructure in gas fields.

The proposals included in the 2016 investment program have been made in line with the provisions of the 2013 -2017 ROMGAZ Business Plan.

Included in the total budget amounting to RON 1,020,000 thousand, the following important investment objectives, representative for the Company’s activity, are going to be performed:

- Exploration works amounting to RON 430,709 thousand;
- Works in production fields, technological surface facilities at producing gas wells, gathering pipes, etc. amounting to approx. RON 127,382 thousand;
- Well re-completion/ reactivation, revamping of motor-compressor installations and capitalizable repairs of the existing pipeline infrastructure amounting to approx. RON 245,550 thousand.



**Substantiation of “new” objectives comprised in the 2016 investment program rests on the following:**

- Obligatory performance of works included in the Concession Agreements concluded with the ANRM (The National Agency for Mineral Resources). In case of *joint ventures*, the substantiation is made by the amount of works committed by the partners for the plan year;
- Reservoir studies performed for producing reservoirs, endorsed by ROMGAZ Technical-Economic Committee;
- Feasibility studies, endorsed by ROMGAZ Technical-Economic Committee (setting up new capacities or increase of the existing ones) or conformation to the findings of inspections performed by state institutions (emergency situations, environment);
  - obligation of performing workover at wells approved in the reservoir studies, endorsed by ANRM;
  - unplanned workover but necessary to optimize gas production of wells representing an investment, in accordance with IFRS;
  - feasibility studies on modernising production facilities in order to ensure an increment of gas production and/ or production safety;
- Necessity to replace fixed assets approved for write off or to provide with new machinery and equipment required to sustain the base activity;
- Implementation of new informational applications (licenses and software) and upgrade of existing software.

#### **VIII. Synthesis of Main Indicators**

	<b>RON million</b>	<b>Achieved 2015</b>	<b>Budget Proposal 2016</b>	<b>Ratios 2016 Budget/ 2015 Achieved %</b>	<b>Budget proposal 2017</b>	<b>Budget proposal 2018</b>
<b>1</b>	Total income	4 530.2	3 810.7	<b>84.12%</b>	4 274.1	4 433.3
<b>2</b>	Total expenses	3 061.4	2 572.5	<b>84.03%</b>	2 878.3	2 984.4
<b>3</b>	<b>Gross result</b>	<b>1 468.8</b>	<b>1 238.2</b>	<b>84.30%</b>	<b>1 395.8</b>	<b>1 449.0</b>

*To be noted that the expense reduction ratio is lower than the estimated income reduction ratio for 2016 as compared to the results of 2015.*

#### **IX. Indicator Forecast for The Period 2017 - 2018**

The 2017 – 2018 forecast rests on those assumptions underlying the substantiation of the 2016 Budget, the market demand and conditions.

**We would like to emphasize that the indicators forecasted for 2017 and 2018 are indicative only and are not the final indicators of the company’s performance for the respective years; they are going to be updated in accordance with the law in force when preparing the budgets for each of the respective years.**

**ROMGAZ Board of Directors endorsed the 2016 Income and Expenditure Budget Proposal and the forecast for 2017 – 2018 in the meeting of May 12, 2016 (Resolution of the Board of Directors No. 11/2016).**

**In accordance with Article 4 paragraph (1) item d) of the Government Ordinance 26/2013, we hereby request the General Meeting of Shareholders to approve the 2016 Income and Expenditure Budget.**

The general frame regarding the Income and Expenditure Budget comprises the following annexes:

- Annex 1: 2016 Income and Expenditure Budget (including estimations for 2017 – 2018); the column related to the current year only is published, in accordance with O.M.F.P. 20/2016.
- Annex 2: Detailed information on the economic-financial indicators included in the income and expenditure budget and their quarterly distribution;
- Annex 3: Total Income Stage of Completion;
- Annex 4: Investment Program, Equipment and Financing Sources;
- Annex 5: Measures to Improve Gross Result and Reduction of Outstanding Payments.

The columns related to years 2017 -2018 from Annex 1 and Annex 2-5 are not public. These may be reviewed only by Romgaz shareholders at the headquarters, daily between 10am – 2pm, as well as in compliance with the procedure described in the Convening Notice of the Ordinary General Meeting of Shareholders (OGMS) on June 16, 2016, (pages 2-3 of the convening notice).

**CHAIRPERSON OF THE BOARD OF DIRECTORS  
AURORA NEGRUȚ**

**ENDORSED,**

**DIRECTOR GENERAL  
VIRGIL MARIUS METEA**



**ECONOMIC DIRECTOR  
LUCIA IONASCU**

**2016 INCOME AND EXPENDITURE BUDGET**

RON thousand

		INDICATORS	Row no.	2016 Budget proposal
0	1	2	3	4
I.		<b>TOTAL INCOME (Row1=Row2+Row5+Row6)</b>	1	<b>3 810 744</b>
	1	Total operating income out of which:	2	3 778 637
		a) subsidies, according to legal provisions in force	3	
		b) transfers, according to legal provisions in force	4	
	2	Financial income	5	32 106
	3	Extraordinary income	6	
II		<b>TOTAL EXPENSES (Row7=Row8+Row20+Row21)</b>	7	<b>2 572 526</b>
	1	Operating expenses, out of which:	8	2 542 133
	A.	expenses for goods and services	9	405 412
	B.	expenses for taxes, duties and similar payments	10	617 124
	C.	personnel-related expenses, out of which:	11	638 335
	C0	expenses for salaries and wages (Row 13+ Row14)	12	494 354
	C1	expenses for salaries	13	442 641
	C2	expenses for bonuses	14	51 713
	C3	other personnel expenses, out of which:	15	1 233
		expenses with termination benefits	16	
	C4	expenses for the mandate contract and for other management and control bodies, committees and commissions	17	3 125
	C5	expenses for social security, special funds and other legal obligations	18	139 623
	D.	other operating expenses	19	881 263
	2	Financial expenses	20	30 393
	3	Extraordinary expenses	21	
III		<b>GROSS RESULT (profit/loss)</b>	22	<b>1 238 218</b>
IV		<b>PROFIT TAX</b>	23	<b>236 544</b>
V		<b>PROFIT AFTER DEDUCTION OF PROFIT TAX, out of which:</b>	24	<b>1 001 674</b>
	1	Legal reserve	25	
	2	Other reserves representing fiscal facilities provided by law	26	
	3	Coverage of accounting loss from previous years	27	
	4	Establishing equity finance for projects co-financed from foreign loans, and establishing sources for reimbursement of installments, payment of interest rates, charges and other costs related to such loans.	28	
	5	Other distributions provided by law	29	
	6	Accounting profit after deduction of the amounts provided at Rws. 25, 26, 27, 28 and 29.	30	1 001 674
	6a	Profit to be distributed from previous years	30 a	150 000
	6b	<b>Total profit to be distributed (30+30a)</b>	30b	<b>1 151 674</b>
	7	Profit share payable to employees within the limit of 10% of the net profit, but not more than one monthly average base salary paid by the economic operator during the reference financial year	31	16 774

RON thousand

		INDICATORS	Row no.	2016 Budget proposal
0	1	2	3	4
	8	Minimum 50% payments to the state budget or local budget in case of autonomous companies, or as dividends paid to shareholders in case of national companies and companies which are fully state-owned or where the state is the major shareholder, out of which:	32	817 914
	a)	- dividends to the state budget	33	572 540
	b)	- dividends to the local budget	33 a	
	c)	- dividends to other shareholders	34	245 374
	9	Profit not allocated to rws. 31-32 is allocated to other reserves and represent the company's own equity finance	35	333 760
VI		INCOME FROM EUROPEAN FUNDS	36	
VII		ELIGIBLE EXPENSES FROM EUROPEAN FUNDS, out of which:	37	
	a)	expenses for materials	38	
	b)	expenses for salaries	39	
	c)	expenses for services	40	
	d)	expenses for promotion and advertising	41	
	e)	other expenses	42	
VII		INVESTMENT FINANCING SOURCES, out of which:	43	1 020 000
	1	Allocations from the budget, out of which:	44	
		budget allocations related to payments of previous years commitments	45	
IX		INVESTMENTS	46	1 020 000
X		SUPPORTING DATA	47	
	1	Forecasted no. of employees at the end of the year	48	6 411
	2	Total average number of employees	49	6 384
	3	Average monthly income per employee (lei/ person) determined on basis of salary-related expenses	50	5 953
	4	Average monthly income per employee (lei/ person) determined on basis of salary expenses (Rw.13/Rw.49)/12*1000	51	5 778
	5	Labour productivity in financial units per total average number of employees in current prices (thousand lei/person) (Rw.2/Rw.49)	52	592
	6	Labour productivity in physical units per total average number of employees (finished goods quantity/person)	53	
	7	Total expenses related to lei 1 000 total income (Rw.7/Rw.1)x1000	54	675
	8	Outstanding payments	55	
	9	Overdue accounts receivables	56	947 800

DIRECTOR GENERAL,  
VIRGIL MARIUS MÊTEA



ECONOMIC DIRECTOR,  
LUCIA IONASCU