POLISH ENERGY PARTNERS CAPITAL GROUP

POLISH ENERGY PARTNERS CAPITAL GROUP DIRECTORS' REPORT FOR 6 MONTHS PERIOD ENDED JUNE 30, 2006

Stephen Klein – President of the Management Board

Anna Kwarcińska – Vicepresident of the Management Board

Michał Kozłowski – Member of the Management Board

Warsaw, August 10, 2006

BUSINESS ACTIVITIES OF POLISH ENERGY PARTNERS S.A. CAPITAL GROUP

The parent company of the Polish Energy Partners S.A. Group is Polish Energy Partners S.A., hereinafter referred to as "Parent Company" which was registered on July 17, 1997 in Entrepreneurs Register held by the city of Warsaw District Court, XX Economic Department of National Court Register, Entry no. KRS 26545. Polish Energy Partners S.A. offers competitive and environmentally-friendly services for the industry to reduce energy supply costs, and produces energy from renewable sources. Polish Energy Partners S.A. effectively combines the ability to develop energy projects with the knowledge required to finance, construct, and operate these projects.

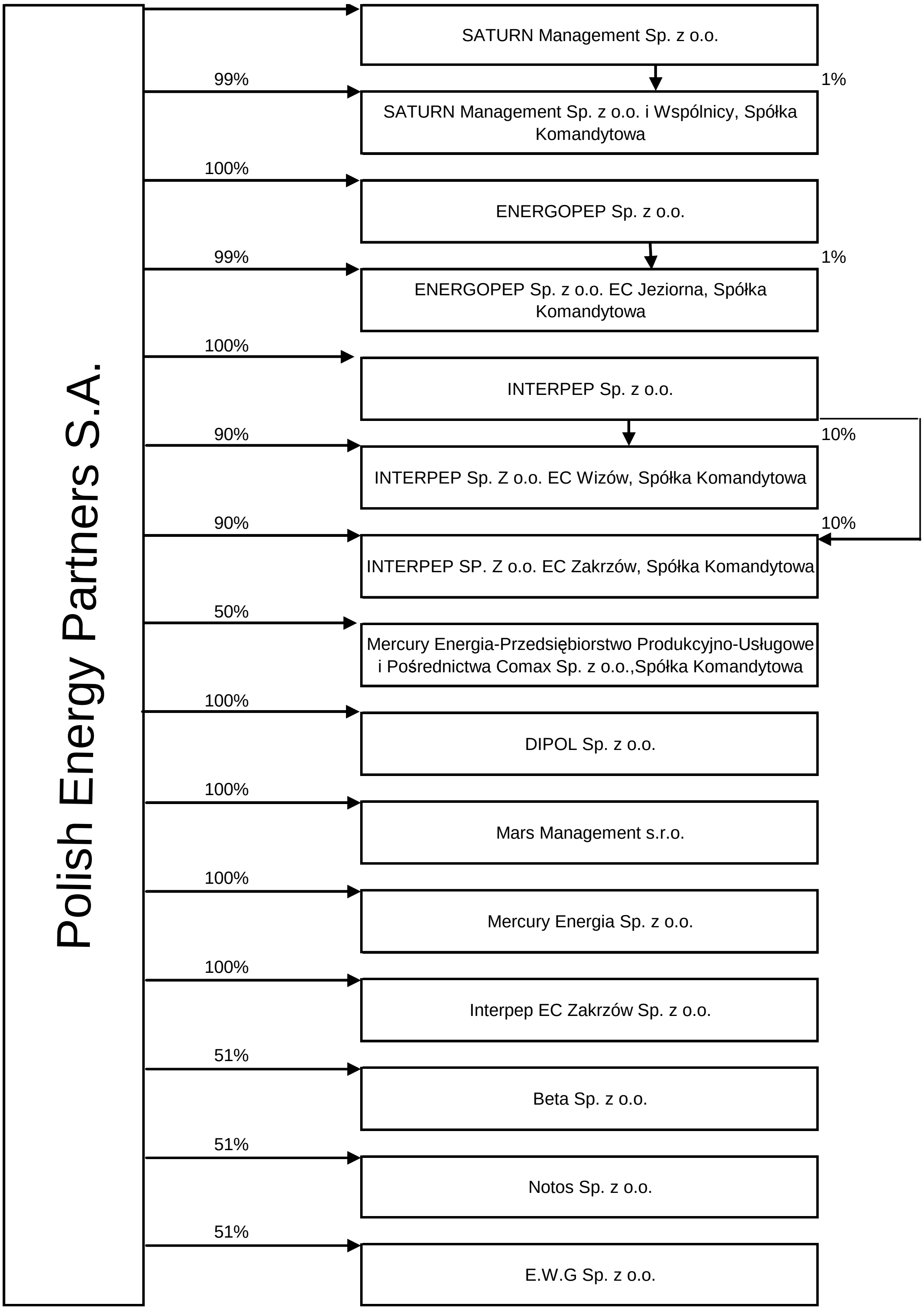
Polish Energy Partners S.A. offers services in the following areas:

- Development – i.e. development and set-up of new projects and organization of project financing sources
- Construction and Operation of energy facilities

Polish Energy Partners S.A. offers its services in two main segments of the energy market:

- Outsourcing of combined heat and power generation for industrial customers, in particular for the paper industry
- Production and supply of renewable energy from biomass and wind.

The Group consists of following entities:



PRINCIPLES OF CONSOLIDATED FINANCIAL STATEMENTS PREPARATION

The principles of consolidated financial statements preparation were described in the introduction to the consolidated financial statements and comparable consolidated financial data.

SHORT DESCRIPTION OF SIGNIFICANT ACHIEVEMENTS OR FAILURES OF THE COMPANY IN THE PERIOD COVERED BY THIS REPORT INCLUDING LIST OF THE MOST IMPORTANT EVENTS RELATING TO THESE ACHIEVEMENTS OR FAILURES

In the first half of 2006 revenues resulting from share of benefits between the Group and one of its clients had significant impact on the reported financial result. The above mentioned benefits result from sale of electricity at preferred prices ("renewable energy", "green energy").

In the first half of 2006 in the wind farm project completed by PEP's subsidiary Dipol Sp. z o.o. the construction works started. The completion of contract is on schedule without delays. The completion of construction works is planned for December 2006 and the commencement of operations for January 2007.

On March 13, 2006 the Company concluded with EPA Sp. z o.o. an annex ("Annex") to an agreement of 15th March 2004 for economic cooperation with regard to development of wind farm projects ("Agreement"). Under the Agreement, the Company and EPA jointly develop projects of wind farms and share the costs of development. The Agreement shall remain in effect by December 31, 2010 (originally, the Agreement was to be effective for three years after the date of the conclusion of the Agreement.) Under the Agreement, the Company has the pre-emptive right of purchase to all projects developed with regard to the Agreement. Moreover, pursuant to the Annex, the price of the next projects for the total nominal capacity of 150MW to be purchased by the Company has been set.

Cost savings program in general and administration costs has been implemented.

Moreover, three wind farm projects with total capacity of 90 MW are in the advanced development stage. The commencement of construction is planned for 2007 and operations for 2008. For the years 2008 and 2009 the Company predicts to complete development of wind farms with total capacity of 74MW and 118 MW respectively.

In course of first half of the 2006 the financial condition of one of the Group's customers, Wizów chemical plant S.A. („Wizów") deteriorated significantly. As a result the bad debt of Wizów significantly increased and the actions which were taken to improve the situation did not succeed. Moreover, in the mid of June 2006 Wizów stopped production. On august 4, 2006 the Group filed with the Regional Court the claim for bankruptcy of Wizów.

As a result of the above facts the Management of the Group took the decision to create revaluation provision for the assets engaged in this project (receivables and fixed assets) and to create necessary provisions for the costs of termination of the project. The detailed presentation of the impairment write down is presented in the Note 41 to the consolidated financial statements.

DESCRIPTION OF FACTORS AND EVENTS ESPECIALLY UNUSUAL IN NATURE WHICH HAVE SIGNIFICANT IMPACT ON THE REPORTED FINANCIAL RESULTS

The profit and loss account as a result of the revaluation provision for the assets engaged in the project and created provisions for other costs related to termination of the project was charged in the following way:

Type of revaluation or provision	**Amount**	**Valuation**	**Recognition in profit and loss account**
Impairment write down of fixed assets	(10,959.4)	Valuation of fixed assets in the net sales price	Other operating cost
Recognition of revenue due from grant received to finance the above fixed assets	980.4	Accelerated settlement to the revenues of grant for the turbogenerator	Other operating revenues
Provision for doubtful debt	(4,650.3)	Full provision for the gross amount of the receivables due	Other operating cost
Other provisions	(1,062.0)	Estimate based on the best knowledge of the Company includes other cost of termination of the project	Other operating cost
Deferred tax on the created revaluations and provisions	2,813.4	Deferred tax asset for temporary differences relating to the above figures	Tax
TOTAL	**12,877.9**		

Had the impact of Wizów project been excluded from the Group results, which is the contribution of the project and the above provision, the profit and loss account of the Group for the 6 months ended June 30, 2006 and the comparable data would have been as presented in the table below:

CONSOLIDATED PROFIT AND LOSS STATEMENT	30.06.2006	30.06.2005
Continued activity		
I. Sales income	27 894	30 263
II. Cost of goods sold	(13 191)	(16 407)
III. Gross profit on sales (I-II)	**14 704**	**13 856**
IV. Selling expense	-	-
V. General and administration costs	(6 999)	(6 843)
including management options valuation	(758)	(700)
VI. Profit on sales (III-IV-V)	**7 704**	**7 013**
VII. Other operating income	63	564
VIII. Other operating expense	(45)	(467)
IX. Operating profit (VI+VII-VIII)	**7 723**	**7 110**
X. Financial income	7 986	6 673
including interest due from lease of assets	994	1 192
XI. Financial expense	(4 859)	(5 181)
XII. Profit/Loss from subordinate units	(22)	(6)
XIII. Gross profit/loss (IX+X-XI+/-XII)	**10 828**	**8 596**
XIV. Corporate income tax	2 443	1 797
XV. Net profit/loss from continued activity	**8 385**	**6 800**
Discontinued activity		
XVI. Profit/loss from discontinued activity	-	-
XVII. Net profit/loss	8 385	6 800
Distribution of profit/loss:	**8 385**	**6 800**
Parent company sharefolders	8 385	6 800
Minority shareholders	-	-

In the first quarter of 2006 revenues resulting from share of benefits between the Group and one of its clients had significant impact on the reported financial result. The above mentioned benefits result from sale of electricity at preferred prices ("renewable energy", "green energy"). These benefits were lower than the benefits achieved in 2005 due to changes in settlement formula with this customer. Moreover, due to bad weather condition in winter time more coal was burnt in the CFB boiler which together with scheduled boiler overhaul caused lower EBITDA than in 2005. However in the second quarter of 2006 the production of green electricity was higher by 19% than in 2005 which contributed to increase in EBITDA level when omitted the impact of Wizów project.

Unrealized foreign exchange differences from balance sheet valuation of assets and liabilities denominated in foreign currency have also significant impact on the Group's results. As of June 30, 2006 the Group had an open active foreign currency position in EURO. Due to depreciation of Polish zloty as of June 30, 2006 in relation to December 31, 2005 the Group realized financial income in the first half of 2006 2,878 thousand zloty as a result of unrealized foreign exchange differences.

EXPLANATION OF SEASONALITY AND CYCLICALITY OF COMPANY'S ACTIVITY IN THE REPORTED PERIOD

The Capital Group PEP operates in the industrial energy outsourcing market. Key accounts consume heat and electricity in its production plants for the production purposes. The demand for heat and electricity for production purposes indicates no seasonality. However some of the heat delivered is consumed to heat the buildings. The above refers both to industrial and municipal offtakers. Demand for building heating indicates seasonality which is higher in 1st and 4th quarter of the financial year. The seasonality of this demand does not have significant impact on the reported financial result.

DESCRIPTION OF MAIN RISKS AND THREATS

Risk Related to Competition

The Issuer is active on the market of industrial energy outsourcing. At present, the PEP Group enjoys a dominant position in this segment of the power market. Given the market's attractiveness for investors, the Company anticipates that competition will intensify, also on part of financially-strong foreign operators, which may affect the PEP Group's ability to attract new outsourcing contracts and to negotiate good terms and conditions of project execution. PEP SA has gathered unique experience on the Polish market in the area of both the development and implementation of optimally-customized technological solutions as well as construction of the right legal, fiscal and financial structures – which secures PEP SA a significant competitive edge. Furthermore, the PEP Group believes it crucial that the provided services are of top quality and that its qualifications are regularly enhanced by know-how relating to cutting-edge technologies and more effective management methods.
Given the steady growth in demand for energy generated from renewable sources (required under regulations currently in force), its small supply, and, as a consequence, the anticipated rise in its prices, investments in green energy generation are becoming increasingly more attractive. Thus, this market segment is likely to also see the tightening of competition. The Issuer plans to launch wind farm operations. Given the weather and environmental constraints in Poland, this is the energy source which in addition to biomass combustion, is viewed as one offering the greatest potential as a source of green energy. This segment of the Polish power market is likely to attract Western European and American companies with relevant experience gathered on other markets. From the project profitability's perspective, the factor of utmost importance is the location of wind farms. The Issuer has concluded an exclusive agreement for development of wind farm projects with Przedsiębiorstwo Projektowo-Serwisowe Elektroniki, Pomiarów i Automatyki EPA Sp. z o.o., a leading developer of wind energy projects in Poland. Under the agreement, PEP SA has access to information on best sites for wind farms, results of wind measurements, and hands-on experience in execution of wind farms in Poland. Thus, the Issuer is provided with an edge over any potential competition, as the gathering of such data is time-consuming and costly.

Risk Related to the General Economic Situation in Poland

Implementation of the strategic goals assumed by the Issuer and the projected financial results are influenced, among others, by macroeconomic factors, which are independent of the Company's activities. These factors include GDP growth, the inflation rate, general situation in Polish economy and changes in the legislation. Unfavorable changes of the macroeconomic indicators may adversely affect the Issuer's projected revenue or increase its operating costs.

Currency Risk

Part of the PEP Group's agreements with its customers provide for payments in foreign currency. Therefore, exchange rate fluctuations can affect the Group's revenue as translated into the Polish currency. The Issuer's Group mitigates the effect of the currency risk on the projects' profitability by using natural hedging – in projects which involve currency conversions into the zloty, the majority of expenses incurred in connection with the construction, upgrading and operation of the CHP plants are borne in the same currency. This also refers to loans incurred to finance the projects.

Interest Rate Risk

The share of debt in the structure of the Group's financing is high. According to the PEP Group's strategy, which assumes maximization of return on equity, 80% of the financing of the projects under development comes in the form of debt. Under loan agreements concluded by the Group companies, interest on the contracted loans accrues at variable rates. A considerable increase in market interest rates above the values projected by the Issuer and assumed in project budgets may adversely affect the PEP Group's financial performance. The Issuer is aware of such risks and in order to prevent their possible adverse effects it continuously monitors the money market situation, efficiently manages its financial resources, and includes in its agreements with customers clauses which provide for the customers' participation in the interest rate risk.

Risk of Fluctuations of Coal and Natural Gas Prices and Risk Related to the Availability of These Resources

The Issuer and its Group companies use natural gas, hard coal and biomass to generate electricity and heat.
In Poland, the PGNiG Group is the main supplier of gas, which comes mainly from Russia. If PGNiG encounters any difficulties in importing the gas in quantities required to satisfy the existing needs, gas supplies to customers may be limited. In a case like this, market prices of natural gas would probably rise, and it could also happen that the Issuer and its Group would not be able to purchase required amounts of the fuel gas. This could limit the business activities of the Issuer and the members of its Group.
The Issuer and its Group have implemented mechanisms intended to protect them against adverse effects of fluctuations of the natural resource prices. As a rule, prices of electricity and heat are linked to prices of hard coal and natural gas. However, there can be no assurance that the financial results of the Issuer and its Group will not be adversely affected in spite of implementing mechanisms protecting against price fluctuations.

Risk Related to Polish Energy Market

The energy market in Poland is regulated. The President of the Energy Regulatory Authority (URE) is the body appointed under the Energy Law to perform tasks related to the regulation of the fuel and energy management and promotion of competition in the power sector. The President of URE's powers and responsibilities include: granting, amending and revoking licenses; approval of draft development plans for power companies; settling disputes between power companies and between power companies and their customers; approval and control of tariffs in the energy sector in terms of their compliance with the regulations, especially with the principle of customer protection against unjustified pricing. The President of URE has the power to impose penalties on licensed operators.
In its present form, the Energy Law substantially ensures covering justified operating expenses of power companies. The producers' right to include their profit in the heat tariffs is limited, particularly by the overriding principles provided for in the energy law, such as the principles of protecting customer interests. Thus, profit earning potential depends, to a large extent, on the company's ability to reduce operating costs.
As the process of implementing competitive market mechanisms in the power sector is well advanced, licensed power producers are exempt from the obligation to file electricity tariffs for approval (subject to certain exceptions). PEP SA's electricity tariffs are not subject to approval by the URE. However, the tariffs must be prepared according to the principles provided for in the Energy Law and secondary legislation thereto. On the other hand, PEP SA is required to draw up heat tariffs and obtain their approval by the URE.
The government may also change its policy and strategy for the power sector in the future.
In the Issuer's case, as well as in the case of all the other companies in the power sector, there is a risk that the URE will refuse to recognize particular expenses borne by the Issuer as justified ones, which may lead to a lack of possibility to recover the expenses through heat charges paid by customers. Similarly, there exists a risk that the URE will not permit, in the future, to increase the prices of the heat energy in proportion to the rise in expenses, or that it will impose penalties on licensed operators. Based on its to-date experience, the Issuer is seeking ways to reduce the risk. Thanks to the use of efficient technological solutions and the Issuer's ability to deliver energy outside

the transmission network (without incurring transmission costs); the prices offered by the PEP Group are competitive in comparison to market prices.

Risk Related to Customers' Financial Standing

The PEP Group derives revenues from developed and implemented industrial energy outsourcing projects under long-term agreements for electricity and heat supplies. Therefore, customers' financial standing and their ability to pay liabilities towards PEP SA constitute a key factor for the success of the projects as well as the PEP Group's financial performance and standing. A sudden fall in energy consumption by a customer may also affect the efficiency of energy generation. Prior to concluding outsourcing agreements and commencing investment projects, the Issuer conducts a thorough analysis of the potential customers, sometimes using the services of external consultants, with a view to assessing the customers' creditworthiness and prospects for their respective sectors. The PEP Group is very careful in selecting its customers from sectors with good market potential. The Issuer analyses in great detail the customer's technological process and the project launch is preceded by several-month cooperation of the two parties.

Risk of Dependence on Key Customers

Every industrial energy outsourcing project, developed and implemented by the Issuer, is in reality prepared for one customer – a production company. To-date, the PEP Group has implemented four projects in this area. The share of each of the Group's customers in the revenue structure exceeded 10%, which means dependence on the customers. With the development of the Group's activity, execution of new outsourcing projects and the Group's expansion on the renewable energy market, particular customers' shares in the revenue structure will be diminishing.

Risk of Loss of Key Personnel

The activities of the Issuer and the Group are based primarily on the knowledge and experience of their highly qualified personnel. Due to the limited availability of experts in industrial energy outsourcing, and the possible attempts by the existing and future competitors to take over the experts by offering them attractive terms of employment and remuneration, there is a risk of losing the employees who are of key importance for the development of the Issuer and its Group. This could adversely affect the Issuer's financial performance and strategy.
The risk is mitigated through:

- High corporate culture of the Issuer, which helps the employees identify themselves with the Company;
- Attractive of remuneration schemes focusing on incentives and promoting loyalty;
- Knowledge management and extensive training programme.

Risk of CHP Plant Operations

CHP plant operations involve the risk of failure to achieve the projected efficiency and availability of the plant, and failure to meet the contractual terms of energy supplies. The Issuer's experience shows that the risk of unexpected breakdowns leading to the plants' operational budget overruns, is limited. To mitigate this risk, PEP SA enhances operational procedures and concludes insurance agreements, or applies contractual clauses whereby any potential additional costs are transferred onto subcontractors.

MANAGEMENT'S OPINION IN RELATION TO THE ACHIEVEMENT OF THE PREVIOUSLY PUBLISHED FORECASTS FOR CURRENT YEAR, TAKING INTO ACCOUNT THE RESULTS PRESENTED IN THE CURRENT REPORT.

The management of the parent company informed in the current report 45/2006 about changes to the forecast previously published forecast in the current report 50/2005 dated November 16, 2005 and amended in the current report 2/2006 dated January 25, 2006 as a result of providing for impairment of fixed assets used to generate and distribution of heat to Wizów and providing for all unpaid overdue receivables and costs related to the probable termination of EC Wizów. The adjusted forecast is presented in the table below:

	Original Forecast	EC Wizów write off & provision	EC Wizów lost contribution	Adjusted Forecast	Comment
Revenues	63,0		(3,7)	59,3	(3.7) of lost revenues from EC Wizów for 7 months;
Adjusted Revenues	65,0		(3,7)	61,3	
EBITDA	19,0	(15,7)	(1,4)	1,9	(15.7) total impact of EC Wizów project gross write off; (1.4) loss of EC Wizów profit for 7 months;
Adjusted EBITDA	21,0	(15,7)	(1,4)	3,9	
Net Profit	12,0	(12,9)	(0,7)	(1,6)	

The management of the parent company informed that since May 22, 2006 Wizów chemical plant S.A. („Wizów") has not effected any payment in order to lower its balance towards parent company or one of its subsidiaries.

Moreover, based on the information of the parent company early June 2006 Wizów stopped production which has not been restored till today.

The parent company in June and July actively participated in the attempts of working out a plan for restructuring of Wizów receivables. However due to reasons out of control of the parent company these actions did not succeed. On July 28, 2006 the last offer for solution of the issue was proposed to Wizów. Wizów however did not respond to this offer. Moreover, till today a reasonable restructuring plan of Wizów financial problems has not been presented to the parent company (although promised many times).

Due to the above the Management of the parent company decided that the only solution in the course of action is to file for bankruptcy of Wizów. The claim has been filed on August 4, 2006.

As a result of the above facts the Management of the Group took the decision to create revaluation provision for the assets engaged in this project (receivables and fixed assets) and to create necessary provisions for the costs of termination of the project.

The Management of the parent company would like to stress that the Group forecast for 2006 presented in the current report 50/2005 would have been met, if the impact of the impairment write down and lost contribution of Wizów would have been omitted.

INDICATION OF FACTORS WHICH MAY HAVE IMPACT IN THE OPINION OF THE COMPANY ON THE ACHIEVED FINANCIAL RESULT WITHIN AT LEAST ONE QUARTER AHEAD

In the opinion of the Company the following factors may have impact on the achieved financial result (both on standalone and consolidated basis) in the period of at least one quarter:

- Macroeconomic situation of Poland;
- EURO foreign exchange against zloty

  In the first half of 2006 which is in the period from January 1, 2006 to June 30, 2006 the impact of unrealized foreign exchange differences on the reported result was positive and amounted to 2,878 thousand zlotys before tax (impact on gross profit) and 2,331 thousand zlotys after tax (impact on net profit).

  In the second half of 2006 which is from July 1, 2006 to December 31, 2006 the changes in foreign exchange of zloty to EURO could have significant impact on unrealized foreign exchange differences. The result on foreign exchange differences in the second half will be dependent on the reasons:

  a) relation of the foreign exchange on December 31, 2006 to the foreign exchange on June 30, 2006 whereas respectively depreciation/appreciation of zloty towards EURO will have positive/negative impact on net profit in the amount of approximately 78 thousand zlotys for each grosz of difference in relation to foreign exchange from June 30, 2006 (4,0434 PLN/EURO),

  b) relation of average foreign exchange on drawing of bank loan denominated in EURO („Loan in EURO") in the second half of 2006 to the foreign exchange on December 31, 2006 whereas respectively depreciation/appreciation of foreign exchange on December 31, 2006 in relation to the average foreign exchange of drawing of Loan in EURO in the second half of 2006 will have negative/positive impact on net profit in the amount of approximately 175 thousand zlotys for each grosz of difference between these foreign exchanges. The above figure is an estimate and assumes average exchange rate of drawing of loan in EURO. The actual amount of impact of valuation of loan in EURO as of December 31, 2006 will depend on actual drawing foreign exchange, which as of the date of this report cannot be estimated reliably. In consequence the actual amount of foreign exchange differences can differ from the above stated figure of impact on one grosz difference in EURO exchange rate.

  The reasons presented in sections a and b cannot be netted off because they depend on different foreign exchange base. The total impact of foreign exchange on net profit of the Group can be estimated by adding up the impact of unrealized foreign exchange differences in first and second half of 2006.

  The forecast of the Group's net result was prepared under assumption of no impact of foreign exchange differences on the forecasted net profit.

- Price of CO2 emission rights
  As of January 1, 2005 the act date December 22, 2004 about CO2 and other substances emission trading (Journal of Laws 281. pos. 2784) which defines the rules for emission trading which has the goal to limit these emissions in an profitable and economically efficient way. PEP Group is subject to this act. Pursuant to the regulation of Ministry Council date December 27, 2005 about acceptance of National Allocation Plan for CO2 emissions in the year 2005-2007 and the list of installations temporarily excluded from the emission trading system in the period from January 1, 2005 to December 31, 2007 the installations belonging to PEP received the emission rights in this period. According to this allocation the yearly emission rights for CO2 in years 2005-2007 amount to 125,500 tons of CO2. Based on the preliminary audited reports

claiming the emission in 2005 erupted by PEP installations the amount of CO2 emissions in 2005 were 89,221 tons. As a result of the concluded by the Group outsourcing contracts the surplus of emission rights over the factual emission in the amount of 8,730 tons will be realized by the Group customers. The 2005 surplus in the amount of 27,549 tons can re realized by the Group in subsequent years. In the years 2006-2007 the Group des not plan emissions above the limit allocated to its installations. In the period from July 1, 2006 and August 10, 2006 the Group sold some CO2 emission rights and received revenues in the amount of 547.8 thousand EURO. The revenue was not recognized in the period ended June 30, 2006 but will be recognized in 3rd quarter of 2006. In 3rd and 4th quarter the Group plans to conclude selling contracts for the remaining CO2 emission rights.

- <u>Changes in prices of "green electricity" certificates</u>
- <u>Changes in prices of coal, gas, biomass and availability of these commodities</u>
- <u>Financial standing of Company's customers.</u>

REMUNERATION OF MANAGING PERSONS

In the first half year ended June 30, 2006 remuneration of the Management Board amounted to:

In thousand zlotys	**30.06.2006**
Management Board	
Stephen Klein	297
Anna Kwarcińska	186
Michał Kozłowski	168

In the periods ended June 30, 2006 and June 30, 2005 the Management Board Members and Supervisory Board Members of the parent company did not receive any remuneration resulting from being in the management boards of related companies.
Till June 30, 2006 the members of the Supervisory Bodies received remuneration in the amount of 178 thousand zlotys, including Mr. Zbigniew Prokopowicz 169 thousand zlotys. The resolution of GSM dated April 27, 2006 established remuneration in the amount of 3 thousand zlotys gross to Mr. Artur Olszewski and Mr. Krzysztof Sędzikowski from April 27, 2006 and June 12, 2006 respectively.

MANAGEMENT REPRESENTATION

Management of Polish Energy Partners S.A. confirms that these consolidated financial statements and comparable data were prepared in accordance with accounting principles and that reflect truly and fairly the financial and material situation of the Group Polish Energy Partners S.A. and the financial result and informs that the Director's report includes the true description of development and achievements and the situation of the Group including description of basic risks and threats.

MANAGEMENT REPRESENTATION ABOUT THE ENTITY TO AUDIT THE FINANCIAL STATEMENTS

Management of Polish Energy Partners S.A. confirms that the entity engaged in the review of half year consolidated financial statements was chosen in compliance with applicable laws and that the entity and the auditors reviewing the consolidated financial statements meet the requirements to issue and independent review report in compliance with applicable domestic law.