# Key risks of PKP CARGO Group

102-15 PKP CARGO Group identifies following areas of risk:

## AREAS OF RISK

ECONOMIC AND MARKET ENVIRONMENT

CONDUCTED OPERATIONS

FINANCE

## Risks related to the economic and market environment

### Risk resulting from the macroeconomic situation

Poland and the Czech Republic are important links in the European supply chain. The condition of their macroeconomic environment (in particular that of Germany, which is the main trading partner of both Poland and the Czech Republic) translates strongly and directly into the economic situation in these countries, having an especially significant impact on the condition of their export industries. This, in turn, affects the volumes of freight available for transport, and consequently influences the PKP CARGO Group's operations, revenues and financial performance.

At the same time, in the coming few quarters the rate of GDP growth in Poland and the Czech Republic (key markets for the provision of transport services by the PKP CARGO Group) is expected to remain at a relatively high level. In parallel, according to the projections published by local and international economic institutions, a gradual slowdown in economic growth should be expected compared to 2018. An upcoming economic downturn in Poland and the Czech Republic is also suggested in the form of the latest values adopted for PMI industry foresight indicators, which in December 2018 in both these countries stood below the level of 50.0 points (which is conventionally considered to be the boundary between expansion and recession in the sector), the lowest for several years.

In addition to external factors, a significant barrier to the rate of GDP growth in Poland and the Czech Republic is currently a shortage of labor available on both markets, which, given their moderate growth in productivity, significantly curtails room for a rapid growth in output. [1]

### Risks associated with the situation on the rail transport market in the main cargo categories

PKP CARGO Group's freight transport continues to focus on the transport of bulk cargo, specifically hard coal, aggregates and construction materials, metal ores and metals, chemicals, coke and refined petroleum products. As a consequence, any change in the economic status quo on these markets directly affects the volume of freight available for transport and thus the quantum of transport and financial performance of the PKP CARGO Group.

The main medium-term risk factors affecting the rate of growth in transport volumes of the PKP CARGO Group include:

- steady decrease in the share of hard coal in Poland's energy mix, although according to the assumptions published by the Ministry of Energy, the absolute consumption of hard coal (approx. 70 million tons annually) should not change significantly in the coming decade or two; [2]
- gradual implementation of EU's climate policy goals – including an increase in the importance of renewable energy sources in the production of electricity, a decrease in $CO_2$ emissions, a general improvement in energy efficiency or the introduction of the "Winter Package" (governing the rules applicable to the internal electricity market in the European Union); [3]
- final result of the pending restructuring processes in the Polish and Czech hard coal mining sectors (including optimization of the sector's cost structure in Poland and planned gradual phasing out of coal extraction in OKD's Czech mines in the coming several years);
- lasting very strong demand for transport of aggregates and construction materials to construction sites of infrastructural projects, which in the context of current renovation and modernization works on PLK's network may result in difficulties with handling the requested freight volumes; [4]
- growing costs of materials and wages coupled with a shortage of qualified workers in the construction sector translating into difficulties in tender processes (because the lowest price proposal is higher than the contracting authority's budget) and in the transition to the project execution phase may adversely affect the sector's growth rate and the scale of construction projects underway; [5]
- uncertainty related to the anticipated increase in real energy prices which translate directly into the competitive strength of the steel and chemical industries (and at the same time their output levels) and the rail transport sector itself; [6]
- expected economic downturn in Poland and abroad suppressing demand for steel products and inputs required for their production (coke, iron ore).

In light of these risks, the PKP CARGO Group takes effective action with a view to reacting swiftly to the changing market situation and existing trends. This approach involves a gradual diversification of transport types (e.g. investments in specialized rolling stock intended for the provision of intermodal transport services) and improvements in the transportation process (which, despite the requirement to use detours and the lower operating speed on PLK's network, enables the timely completion of contracts).

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[1] National Bank of Poland, Ministry of Finance of the Czech Republic

[2] Ministry of Energy: "Poland's Energy Policy until 2040"

[3] Ministry of Energy: "Poland's Energy Policy until 2040"

[4] "Kierunek Surowce" [Direction: Commodities] portal

[5] wnp.pl website

[6] wnp.pl website

### Risk associated with the rail freight sector

In accordance with the data provided by the Office of Rail Transport, the total number of 71 rail operators, including PKP CARGO S.A. and PKP CARGO SERVICE sp. z o.o., offered the rail freight service on the Polish market in 2018. [7] At the same time, the domestic market of cargo transport by rail has been considerably decentralized in recent years, which has been influenced by liberalization of the laws regulating the activity of the entities operating there. The market significance of small rail operators with the individual share of up to 2% has strongly increased (in particular at the expense of large operators) in recent quarters. Currently, their total share constitutes over 15% of the market in terms of both freight volume and freight turnover. [8] The PKP CARGO Group's competitors offer a broad range of transport services, including whole-train transport of coal, aggregates and other dry bulk cargoes, liquid fuels and chemicals. Some companies also have single-wagon transport on offer. In recent quarters, entities focusing exclusively on container (intermodal) transport have appeared on the market. In the face of lower market entry barriers and good prospects for, among others, the segment of intermodal transport, a further increase in the number of PKP CARGO Group's competitors and a dynamic growth of the existing entities in the coming quarters cannot be excluded.

The main competitors for PKP CARGO Group entities (AWT and PKP CARGO S.A.) in the Czech Republic are ČD CARGO (a strong leader on the transport market), Metrans Rail, Unipetrol Doprava, and IDS Cargo. [9] As is the case in Poland, transport services provided by competing rail operators chiefly include such transport market segments as: coal, bulk materials, liquid fuels, chemicals and intermodal transport.

In the face of an increasing competition on the rail market, the activities of the PKP CARGO Group are oriented towards continuous improvement of the quality of the provided transport services and their development (such as investing in the rolling stock and signing cross-border cooperation agreements with local rail operators) and offering a comprehensive logistics service for enterprises operating in various branches of the industry.

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[7] Office of Rail Transport

[8] Office of Rail Transport

[9] SZDC (http://www.szdc.cz)

## Risks in the operations conducted

### Risk associated with the rail infrastructure

The executed contracts describe the principles of cooperation when monitoring the effectiveness of the existing arrangements and the procedure to be applied in the case of shared risk for the purpose of adopting and introducing the necessary changes, including the tasks and responsibilities of the individual participants in the process (e.g. contracts on using the allocated train routes between PKP CARGO S.A. and the infrastructure administrator for which the part "B" certificate has been issued to PKP CARGO S.A.). Any and all irregularities related to the infrastructure found by employees are communicated to administrators on an ongoing basis. Moreover, periodic meetings and conferences are organized to discuss the irregularities and measures aimed to both eliminate them and prevent the occurrence of similar situations in the future.

### Transport safety

From the viewpoint of rail traffic safety, PKP CARGO S.A. operates based on relevant part A and part B safety certificates issued by the President of the Office of Rail Transport. The basic requirement for obtaining the certificates necessary to pursue an independent business activity was to implement the Safety Management System (SMS), and it was satisfied in 2009.

The SMS covers risks related to the pursued activity and provides for appropriate supervision and control measures in order to reduce them and ensure the appropriate safety level:

- the risk arisen from a direct activity, including occupational risk (related to the performed work) and technical risk (related to the rolling stock and technical resources used);
- the shared risk, which is a risk arisen from an interaction between the entities being part of the railway system (e.g. infrastructure administrators, other rail operators, entities in charge of maintenance);
- the risk of third parties, which are not directly involved in the operation of the railway system.

Moreover, the processes and procedures serving the purpose of monitoring the effectiveness of the measures taken in the area of risk supervision and introducing the necessary changes are applied within the SMS: The changes concern:

- technology and methods;
- operating procedures, rules and standards;
- organizational structure.

### Risk associated with changes of legal regulations

## Technical specifications for interoperability Noise (NOI TSI)

In 2018, works were performed to amend the Technical Specifications for Interoperability relating to the subsystem 'Rolling stock - Noise' ('Noise TSI').

The deadline for adopting the amendments determining, among others, the period for decommissioning freight cars equipped with cast iron brake blocks, specifying access to some routes for modernized or non-modernized freight cars was set for the beginning of 2019.

On 31 January 2019, the EU Member States adopted amendments to Noise TSI at a meeting of the Railway Interoperability and Safety Committee. In the course of the works, Poland managed to negotiate the so-called special case providing for further operation of freight cars with tyred wheels, which constitute a considerable number of PKP CARGO S.A.'s freight cars. Such vehicles may be used in domestic transport regardless of the line status until the end of 2036. They may also enter the Czech Republic and Slovakia without limitations until the end of 2026. This will prevent considerable costs involved in adapting to the new requirements.

## Service Infrastructure Facilities

The Act of 16 November 2016 Amending the Act on Rail Transport and Certain Other Acts entered into force on 30 December 2016. The purpose of the Act is to adjust the national legal order in the field of rail transport to the changes resulting from Directive 2012/34/EU of the European Parliament and of the Council of EU. The Act specifies, among others, a new group of facilities, the so-called service facilities, designated for the provision of services necessary to perform the transport process.

In connection with the amendment, in 2017 the Company introduced a number of organizational changes in order to appoint the service facility operators.

Another legal act regulating the operations of the service facilities in detail, i.e. Commission Implementing Regulation (EU) 2017/2177 of 22 November 2017 on access to service facilities and rail-related services which entered into effect on 13 December 2017. In 2016 and 2017, the Company participated in the works of the legal group of CER (Community of European Railway and Rail Infrastructure Authorities) which presented to the European Commission a number of the Company's postulates. They are to some extent taken into account in the Regulation. Since the Regulation will enter into force on 1 May 2019, the Company is performing works on adapting the Bylaws for access to PKP CARGO S.A.'s Service Infrastructure Facilities to the provisions of the Regulation.

The intended amendments are for specification rather than principal purposes. Their entry into force might involve the necessity to perform some additional duties by PKP CARGO S.A. employees handling Service Infrastructure Facilities, yet the planned amendments are not expected to have a significant influence on the Company's financial performance.

## EU Emissions Trading Scheme (EU ETS)

One should consider the planned changes in the EU Emissions Trading Scheme (EU ETS) – the related uncertainty was the reason why the Company's client, ArcelorMittal Poland (AMP), suspended its decision to overhaul the blast furnace no. 2 in Dąbrowa Górnicza. Finally, AMP decided to carry out the overhaul in the period July-August 2018. The modernization lengthened the furnace useful life by three to five years. This will make it possible to assess the financial impact on AMT of the amendments to the EU ETS to become effective in 2021. Only then will it be known whether a general overhaul of the blast furnace is economically viable. The phasing out of the blast furnace at the end of July and at the beginning of August 2018 did not have a major impact on the quantum of transport services provided by PKP CARGO S.A. to AMP.

## Other changes in the regulatory environment

- Regulation (EU) 2016/679 of the European Parliament and of the Council of 27 April 2016 on the protection of natural persons with regard to the processing of personal data and on the free movement of such data ("GDPR"), and repealing Directive 95/46/EC (General Data Protection Regulation) entered into force on 25 May 2018 - the absence of consistent procedures for information protection, including personal data protection might result in unauthorized access to or, in extreme cases, disclosure of such information outside the Group. PKP CARGO S.A. appointed a data controller responsible for all issues related to increasing the legal standards for securing the information containing personal data. Moreover, the provisions regarding the rights and obligations arising from the GDPR were implemented, among others, to trade agreements, tendering documents, IT agreements.
- The new provisions of the Act of 9 March 2017 on the Monitoring System for the Carriage of Goods by Road and Rail entered into force on 14 June 2018. They are significant for the Company since the goods provided for in the Act may be transported exclusively upon submitting a notification to the Electronic Goods Monitoring System (SENT) and obtaining the so-called Reference Number. The obligation to submit, supplement and update notifications is imposed on the entity sending the goods (or the sender), the entity

receiving the goods (or the recipient) and the rail operator, respectively; the Act specifically defines the entities, scope of their respective responsibilities and introduces financial sanctions for breaching the obligations imposed under the Act.

- The Act of 15 December 2017 Amending the VAT Act and Certain Other Acts introduced, among others, the so-called Split Payment mechanism on 1 July 2018. This obligation required that PKP CARGO prepare the SAP system for generating bank statements with VAT amounts indicated and develop a function of controlling the amounts of payments exclusive of VAT made by PKP CARGO S.A.'s customers. Furthermore, the adaptation of the SAP BW system was required also by the Regulation of the Minister of Finance of 18 April 2018 on templates of VAT returns.
- The provisions of the Regulation of the Minister of Infrastructure on the list of positions directly associated.
- with rail traffic management and safety and the conditions to be met by persons employed on such positions and rail vehicle drivers of 16 August 2004 were repealed on 29 October 2018. As regards train engineers, the Company found the amendment significant and therefore the internal regulations on the principles of training train engineers and issuing licenses were updated accordingly. The works on adapting the training system in the Company were performed gradually and, in that period, train engineers received licenses issued by the Office of Rail Transport, which constituted the basis for issuing certificates, whereas new train engineers were trained in accordance with the new rules.
- The provisions of the Regulation of the Minister of Infrastructure and Development of 10 February 2014 on a train engineer certificate, regarding training with the use of a traction unit simulator, entered into force on 1 January 2019. The relevant activities regarding the adaptation to the said regulation are performed or supervised in the Company by the competent substantive unit.

### Road transport constitutes increasing competition for the Group

In 2018, the rail freight transport in Poland grew dynamically (+4.1% yoy). At the same time, the volume of cargo transported by trucks increased even more, i.e. by 18.1% yoy. [10] In recent years, road transport of goods has managed a vast majority of the incremental freight volume on the Polish and Czech markets, which translates into a gradual growth of its share in the entire sector of transport for these countries. The car transport significance growth is to a large extent underlain by its competitive advantages with respect to other branches of land transport of goods.

The measures taken by the PKP CARGO Group are aimed at the railway achieving the position of a means of transport that would be complementary to road transport (e.g. long-distance transportation of high volumes of bulk cargo by rail and their handling by trucks as part of the so-called last mile). At the same time, the schedule speed should increase and the transport routes should be shortened in terms of operation on the completion of the modernization works in the PLK network as part of the "National Railway Program". This will also result in a significant improvement of the competitive position of railway with respect to other means of transport of goods.

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[10] Central Statistical Office of Poland, enterprises with > 9 employees, excluding economic transport

### The risk of high dependence of the client base on the limited number of industries and business entities operating therein as well as structural changes in the operations of key accounts

A considerable number of contracts executed by the PKP CARGO Group with business partners are long-term contracts. Hence, it is possible to contract transportation of large volumes of bulk cargo such as hard coal, aggregates, metals or ores, sufficiently in advance. The contracts specify the declared transport volume and, in reasonable cases, its later modification (both increase and decrease) may be negotiated. As a consequence, this can both mean the necessity to obtain additional resources in order to transport extra cargo and translate into the necessity to reduce the scale of the PKP CARGO Group's actual transport.

At the same time, the transformations of the structure of the entities to which the PKP CARGO Group provides transport services might assume the form of a complete change or diversification of the area of activity. It is also possible to establish subsidiaries focusing on providing transport services covering the goods manufactured by a given enterprise. There are currently several operators of this kind in the domestic rail freight but they do not have the sufficient rolling stock to be able to handle the whole volume of cargo commissioned by parent companies. There is a risk that their significance in transport for the parent company will gradually increase, which, in consequence, could decrease the volumes of goods available for acquisition by the PKP CARGO Group. However, with time, the said entities might decide to provide transport services also to other enterprises (e.g. from a given sector, using the know-how and the matching rolling stock) and thus commence an activity competitive to the PKP CARGO Group in a broader market. The PKP CARGO Group's long-term strategy assumes a gradual improvement of efficiency, competitiveness and quality of the transport and logistics services offered. The measures taken reduce the risk of potential diversification of rail operators by key accounts.

### Risk associated with shortage of trained personnel

The rail transport industry and in particular positions associated with rail transport safety require ongoing update of knowledge and acquisition of skills. This objective is achieved through obligatory training courses delivered in the form of e.g. periodic knowledge updates, tutorials and examinations. The effect of the continuous training process is obtainment of licenses and improvement of qualifications by the personnel.

In 2018, the adaptation program was adjusted to the needs and expectations of various groups of positions: administrative employees, non-administrative employees working in the Company's facilities and managerial staff. For employees in positions directly associated with the transport process, a series of training sessions was updated thus allowing them to obtain required professional qualifications. A carefully selected professional training program is supposed to ensure that new employees are integrated into the organization and familiarized with their duties as soon as possible and to help them adapt to the working environment, which influences the effectiveness of the performed works and minimizes the risk of employee fluctuation.

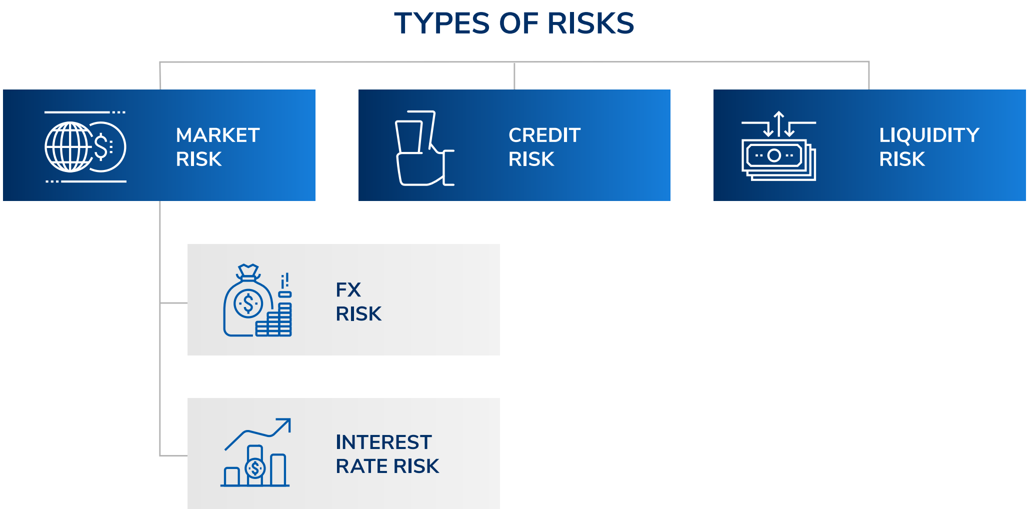
### Risk of collective disputes and strike

Owing to the dialog carried out by the PKP CARGO S.A. Management Board with the Trade Unions, the Trade Unions not initiate any collective dispute or strike in the Company in the reporting period. This made it possible to perform the expected tasks in a spirit of social peace. In June 2018, as a result of arrangements between the Management Board and Trade Unions, a pay rise was introduced for the Company employees as of 1 September 2018.

### Risk of increase of salaries

On the delivery date of this report, trade unions did not apply for wage increases.

## Financial risks




### Liquidity risk

The Group is exposed to liquidity risk following from the ratio of current assets to net current liabilities (current liabilities without short-term provisions). In 2018, the Group's liquidity remained at the level that ensured timely payment of all due and payable liabilities. To ensure an additional source of funds required to secure its financial liquidity, the Group used external financing sources, such as a current account overdraft facility.

Information on credit facilities undrawn as at 31 December 2018 is presented in Note 4.1 to the SFS and Note 4.1 to the CFS for 2018.

Additionally, in order to optimize financial expenses in the PKP CARGO Group, a cash pooling system is in place which comprises, as at 31 December 2018, 7 Group companies.

### Market risk

The Group is exposed to market risks associated with changes of the exchange rates and interest rates. The objective of the market risk management process is to limit undesirable impact of changes of market risk factors on the cash flows and results in the short- and medium-term. The Group manages the market risk following from the aforementioned factors on the basis of internal procedures which define the rules of measurement of individual exposures, parameters and time horizon.

The principles of market risk management are implemented through assigned organizational units under the supervision of the Parent Company's Management Board. Market risk management is executed based on developed strategies, with partial utilization of derivative instruments. Derivative instruments are used only to limit the risk of cash flow changes. Transactions are entered into only with reliable partners, admitted to participation as a result of application of internal procedures and execution of appropriate documentation.

### FX risk

In 2018, the Group was exposed to FX risk resulting from the receivables, payables and cash denominated in foreign currencies. The Group's receivables expressed in foreign currencies are short-term receivables with the maturity up to 1 month and payables expressed in foreign currencies are mostly short- and long-term liabilities on account of investment loan agreements with maturities until the year 2031.

The balance sheet valuation of receivables and some current and non-current liabilities long-term liabilities expressed in foreign currencies, settlements in foreign currencies both on the side of receivables and liabilities, lead to financial revenues (positive FX differences) and financial expenses (negative FX differences). The level of financial revenues and financial expenses fluctuates during the year, which is caused by changes in the exchange rates.

Cash in foreign currencies deposited on bank accounts follow from timing mismatch of receipts and expenditures and the surplus of receipts over expenditures. In the long run, the valuation risk matches the risk of change of cash flows, therefore it is the cash flows, not balance sheet items, that are subject to hedging transactions.

For the EUR/PLN exchange rate, there is partial natural hedging due to the fact that proceeds in EUR are partly balanced out by expenditures in the same currency. The FX risk management transactions used by the Group are aimed at hedging the net free position (understood as the difference between FX proceeds and expenditures) exposed to change of the value in PLN.

According to the Financial Risk Management Policy prevailing in the PKP CARGO Group, in 2018, FX risk management transactions were used for the EUR/PLN currency pair.

Forward transactions were used to hedge FX risk in 2018. In 2018, the Group hedged the surplus in EUR through forward transactions on the EUR/PLN pair at the levels and with transaction maturities determined in accordance with the procedures of the Financial Risk Management Policy.

The Parent Company used hedge accounting for all EUR loans and Forward transactions. At the same time, PKP CARGO CONNECT Sp. z o.o. applied hedge accounting for forward transactions.

## Interest rate risk

Most financial investments made by the Group as at the end of 2018 were bank deposits, which were concluded mainly for the period from a few days up to 5 months, depending on the Company's liquidity needs.

In addition, the Group is exposed to the risk of volatility of interest rate cash flows following from bank loans, leasing based on variable interest rates. Interest on lease agreements was accrued according to the reference rates increased by the financing party's margin. The reference rate for agreements denominated in EUR is EURIBOR 6M and for agreements signed in PLN – WIBOR 1M. The interest rate risk in leasing agreements is executed through revaluation of leasing installments in the periods of 1 month, 6 months, depending on the agreement.

Interest on loan agreements were accrued according to the WIBOR 1M, WIBOR 3M, EURIBOR 3M and PRIBOR 3M reference rates plus the banks' margins. The interest rate risk in loan agreements were executed through revaluation of loan installments in monthly, quarterly and semi-annual periods.

At the same time, in accordance with the financial risk management policy prevailing in the Group, one of the Group companies applied interest rate hedging transactions, the so-called IRS.

## Credit risk

Conducting its commercial activity the Group sells services to business entities with a deferred payment date, which may lead to the risk of counterparties defaulting with meeting the deadlines for payment of the amounts due for the provided services. To minimize the credit risk, the Group manages the risk through a prevailing client creditworthiness assessment procedure. This assessment is carried out for all clients who use a deferred payment date. As part of its internal policy, the Company makes application of the deferred term of payment conditional on acceptability of the business partner's condition and positive history of cooperation.

Receivables from business partners are monitored on a regular basis. In the case of overdue receivables, in accordance with prevailing procedures, the delivery of services is suspended and recovery procedures are triggered.

Concentration of risk associated with trade receivables is limited due to the large number of business partners with commercial credit dispersed among different sectors of economy. In addition, to reduce the risk of problems with recovery of trade receivables, the Company accepts security interests from their customers in the form of, among others: bank/insurance guarantees, assignment of contracts, security deposits and promissory notes.

The credit risk associated with cash and bank deposits is perceived as low. All entities in which the Group invests free cash operate in the financial sector.

The maximum exposure to credit risk is presented by balance sheet balances of trade and other receivables, cash and other financial assets. This exposure is limited through securities established in favor of the Group (in the form of, inter alia, bank/insurance guarantees, guarantee deposits).