Lietuvos energija | GAMYBA

Lietuvos Energijos Gamyba, AB
Business Strategy Summary
2014–2020

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PURPOSE OF THE DOCUMENT

The document 'Lietuvos Energijos Gamyba, AB Business Strategy 2014-2020' (hereinafter referred to as the 'Strategy'), defines the long-term strategy of activities of Lietuvos Energijos Gamyba, AB ('the Company' or LEG): the strategic directions and objectives of operations and the indicators measuring the implementation of the Strategy.

In order to describe the environment in which the Company operates, the document analyses the factors having the greatest impact on the Company's operations over a period of seven years. Upon formulating assumptions based on these factors, projections of the Company's operating results are made.

A three-year operating plan of the Company has been prepared on the basis of the business strategy of the Company. It sets out both short- and long-term measures aimed at the implementation of the Strategy.

This document is a short version of the full LEG Strategy, prepared with due regard to the confidentiality requirements set for companies the shares of which are listed on a stock exchange.

STRATEGY IN BRIEF

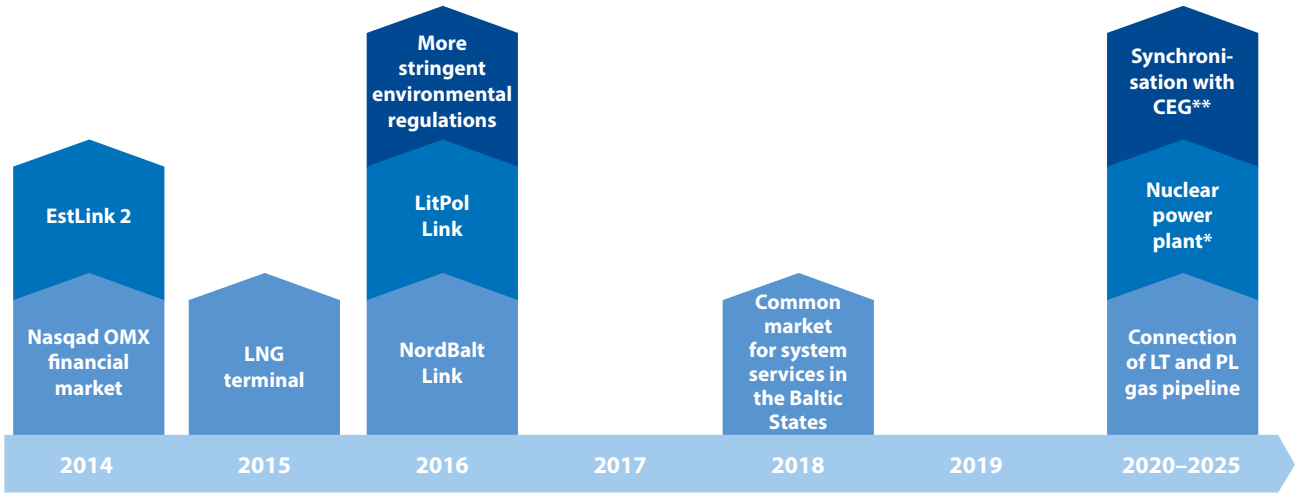
LEG is a company of strategic significance, engaged in the generation of electricity and heat, electricity import, export and trade, and the provision of system services to the transmission system operator.

LEG operations are divided into two key areas: regulated and commercial. Regulated activities include the subsidised generation of electricity and heat at the Elektrėnai Complex (EC), the power reserving services at the EC and the Kruonis Pumped Storage Hydroelectric Plant (Kruonis PSHP), and the reactive power control service provided by the Kruonis PSHP units operating in the synchronous condenser mode. Commercial activities consist of electricity generation at the Kruonis PSHP and the Kaunas Hydroelectric Power Plant (Kaunas HPP), wholesale trade in electricity in the free market and other commercial services.

Compared with competitors in the neighbouring countries, LEG has unique electric power accumulation capacities in its possession (at Kruonis PSHP). The flexibility of the capacities under its control enables the Company to participate in the electricity regulation market. Still, LEG's production portfolio is less attractive compared with that of the competitors due to non-competitive production at EC, outdated technologies, and insufficient process efficiency. The Company's operations are sensitive to changes in the legal and regulatory environment, and projects planned for the energy sectors of both Lithuania and the neighbouring markets for the nearest decade may have a direct effect upon them (see Figure 1).

Figure 1

Main energy sector events in 2014-2020



Note: The timing shown here may change depending on specific circumstances of the projects.

** Depending on decisions on the implementation of the nuclear power plant project.*
*** Depending on decisions on synchronisation with the continental Europe network.*

The Company has formulated its business strategy for 2014-2020 and has set ambitious strategic objectives, identifying the expected outputs focussed on the shareholder's objective, based on an analysis of both internal and external factors and the most probable assumptions relevant to LEG's operations.

Vision of the Company: To be the national producer of electric energy and efficiently operate in the integrated European electricity market.

The Strategy envisages that in 2014–2020:

- profitability of LEG will increase in accordance with the general objectives of the Group provided for in the strategy of Lietuvos Energija UAB, the main shareholder of the Company;
- until 2019, revenues of LEG will decrease due to stronger competition on the exchange and shrinking production volumes at the Elektrėnai Complex (market liberalisation effect), however, later stabilisation is expected due to additional revenues from commercial activities of the Company;
- approximately LTL 450 – 650 million will be invested in the two main development projects (the biofuel thermal power plant and (if market conditions are favourable) the construction of Unit 5 of Kruonis PSHP).

The strategic objectives of the Company will be attained by working along the four strategic directions:

- **Increase value of the Company:** By consistently increasing the profitability of commercial activities; eliminating those production capacities that are not in use; investing in the modernisation of other capacities; increasing process efficiency and cutting operating costs.
- **Ensure quality of service to the clients (TSO, suppliers, customers):** By reducing the dependence on the state support (public interest services (PIS)); formulating an electricity portfolio that is in line with the wishes of electricity suppliers; ensuring optimal electricity prices for suppliers and end customers; fulfilling the obligations of a socially responsible company to the public and increasing the focus on environmental protection.
- **Increase operational efficiency:** By reviewing and optimising the business principles through the use of LEAN principles and tools; improving project management; developing the employees' competences; optimising the production capacities under the Company's control and abandoning those units which are not used in full.
- **Create an organisational culture based on corporate values:** By increasing the employees' involvement and developing the leadership competences; ensuring continuity of business by planning future competence requirements and organising timely employee training and/or requalification; attracting and retaining human resources, reducing the scope of key employees' turnover, implementing and consistently applying the system of providing replacement/substitute personnel; and effecting a cultural change in the health and safety at work area.

Internal Environment

Management Reforms

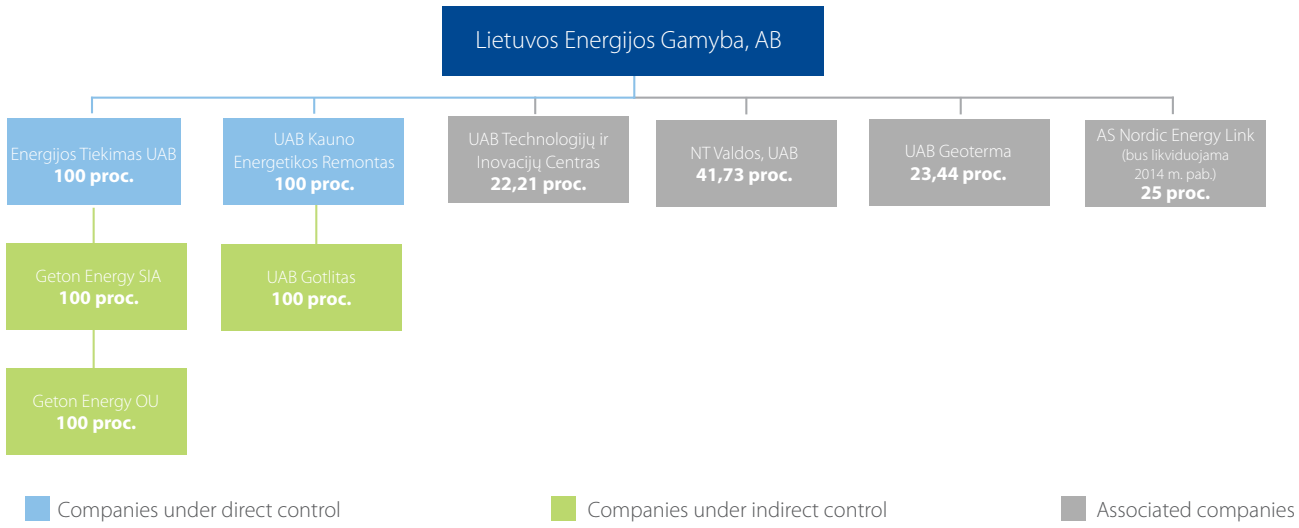
The general meeting of shareholders of Lietuvos Energija, AB held on 29 July 2013 adopted a decision to rename the company into Lietuvos Energijos Gamyba, AB. The Company forms part of the group of energy sector companies operating under the name of Lietuvos Energija, UAB (former Visagino Atominė Elektrinė UAB) (hereinafter referred to as the 'Group'). In order to increase the efficiency and transparency of the Group's activities, the Ministry of Finance of the Republic of Lithuania, a shareholder of the Group, initiated the Group's management reform process in the first half-year of 2013. Its essence lies in a clearer definition of responsibilities of management and supervision bodies, election of supervisory councils and boards and reinforcement of corporate management by establishing a management and control system that would help ensure an effective attainment of the objectives of the shareholder as well as augmentation of the long-term value in a socially responsible way.

The first phase of the reform process, during which amendments to the Articles of Association of the Group's companies had been made and the supervisory councils and the board had been elected, was completed in October 2013. It is followed by the adoption and implementation of far reaching decisions of strategic and systematic nature, which contributes to the achievement of the main aims of the reform: to increase both the long-term value of the Group in a socially responsible way and the return on capital invested by the shareholder by balancing the interests of the State as a shareholder and the interests and expectations of other stakeholders.

Information about LEG Group

As of April 2014 the Company had direct control over the following subsidiaries: Kauno Energetikos Remontas UAB and Energijos Tiekimas UAB. Indirectly, the Company holds the majority of votes (100 % of the shares) in Gotlitas UAB via Kauno Energetikos Remontas UAB, as well as in Geton Energy OÜ and Geton Energy SIA via Energijos Tiekimas UAB. Apart from the said subsidiaries, the Company takes part in the management of the following associated companies: Geoterma UAB (23.44 % of shares), NT Valdos UAB (41.74 % of shares), Technologijų ir Inovacijų Centras UAB (22.21 %) and AS Nordic Energy Link (25 %) which is going to be dissolved in 2014 (AS Nordic Energy Link was established specifically for the implementation of EstLink 1 project connecting the energy systems of the Baltic States and Finland by constructing a power cable on the Baltic Sea bed. The shareholders' agreement states that the operations of the company will be terminated upon transfer of the EstLink 1 power cable to the Estonian and Finnish transmission system operators in 2014). The structure of LEG Group is shown in Figure 2.

Figure 2
Structure of LEG Group



LEG Operations in 2013

Production

The Company holds permits to produce electricity, issued for an indefinite term. The Company generates electricity at three power plants under its control: the Elektrėnai Complex having a reserve power plant and a combined-cycle unit, the Kruonis Pumped Storage Hydroelectric Plant and the Kaunas Hydroelectric Power Plant. In 2013, the EC produced 1.10 TWh, Kruonis PSHP 0.54 TWh and the Kaunas HPP 0.42 TWh of electricity (2012: 1.40 TWh, 0.47 TWh and 0.31 TWh respectively). Electricity generated by the LEG-controlled power plants accounted for approx. 18.2% of the national demand in 2013. A decrease in the production volumes in 2013 was mainly determined by the reduction of the supported electricity generation quota for EC. The actual decrease was partly compensated, in the reporting period, by the larger power generation volumes at the Kruonis PSHP and the Kaunas HPP.

The EC uses organic fuel for the production of both electricity and heat. Heat energy is supplied to residents and enterprises of the Elektrėnai Municipality including Kietaviškių Gausa, a greenhouse complex. The Company's heat production and trading operations are regulated by the National Commission for Energy Control and Prices (NCECP), which has issued a decision on non-recognition of the actually incurred fuel costs, as a result of which heat generation is a loss-making activity for the Company. It is expected that, on completion of the project on the construction of new heat generation capacities at Elektrėnai at the end of 2014, the NCECP will start recognising all the costs of regulated activities related to the heat generation as eligible costs and these activities will be not loss-making starting from 2015.

LEG places emphasis of renewable energy sources. Both the Kaunas HPP and the Kruonis PSHP use hydroenergy for power generation, as a clean and flexible national energy resources that is never depleted. In order to diversify its energy generation sources and to further develop the use of the renewable energy sources in Lithuania, the Company intends to start using biofuel in the heat generation process.

Trading in Lithuania

The Company is engaged in wholesale electricity trading (i. e. in the environment of relations between electricity generating companies and suppliers). The Company sells electricity and provides power balancing services to both public and independent suppliers operating in the Lithuanian market. In 2013, LEG sold 3.6 TWh of electricity in the domestic market (2012: 3.7 TWh). In addition, since 8 January 2013 the Company has been performing the functions of a designated company, i. e. it buys all the electricity generated in wind farms based on forecasts and sells it in the Lithuanian bidding area of Nord Pool Spot (NPS) electricity exchange. The amount of electricity bought from the wind farms and sold on the exchange in 2013 totals 0.47 TWh.

Trading with Foreign Countries

In 2013 the Company imported/exported electricity from/to Estonia and Latvia. Imports total 0.73 TWh and exports total 0.07 TWh of electricity in 2013 (2012: 0.83 TWh and 0.5 TWh respectively). Since 3 June 2013 (i. e. since Latvia's joining the NPS), the Company has been trading only in the Lithuanian bidding area of NPS.

Other Services

The Company also provides system services to the Lithuanian transmission system operator (TSO). System services are designed for ensuring the stability and reliability of the functioning of the energy system, the prevention of and response to emergencies in the system, and the requisite power reserve while complying with the established requirements for the quality and reliability of the electricity supply. System services include the power reserving, trading in regulation power and balancing power, reactive power control and system recovery services. Since the beginning of 2014, the Lithuanian TSO is ordering only one instead of two Kruonis PSPP units from LEG's secondary reserve. This has led to lower profitability of the Kruonis PSHP's operations. For more information about system services please see Annex 1 to this document.

Structure and Employees of the Company

LEG was established upon merging of two companies, Lietuvos Energija AB and Lietuvos Elektrinė AB. In 2011–2013, the organisational structure underwent important changes, with indirect functions eliminated from the power plants: all the service functions such as financial, procurement, legal, human resources and communication were concentrated at the headquarters thus cutting administration costs of the Company.

LEG's organisational structure comprises six departments: Production, Wholesale Electricity Trade, Finance and Legal, Prevention and Control, Human Resources and Administration, and Business Development, plus the Internal Audit Unit. LEG's organisational structure is provided in Annex 2.

In 2013 the Company employed 501 people including 408 in the Production Department.

The main aim of the corporate human resources policy is to recruit and maintain employees with high-qualifications, promote their involvement, develop the long-term partnership relations with them following the principle of mutual value, and create a successful future for the Company.

External Environment

European Union Legal Framework

REMIT

In 2011, the Regulation of the European Parliament and of the Council No 1227/2011 on wholesale energy market integrity and transparency (REMIT) was adopted in order to prevent market manipulation and insider trading in the wholesale electricity and gas markets.

REMIT obligates energy companies to inform the Agency for Cooperation of Energy Regulators (ACER) about all the transactions of trading in electricity and natural gas and the related derivative financial instruments' trading transactions.

According to the REMIT's provisions, LEG is obliged to notify the following transactions:

- day ahead trading, intraday trading, weekly trading, weekend trading;
- long-term contracts;
- contracts with end customers whose actual consumption is from 600 GWh/year (or whose installations technically allow such amounts);
- derivative financial instrument transactions;
- other contracts included in the list approved by the European Commission.

In order to fulfil the obligations set in REMIT, the Company intends to put the transaction notification processes in place and to appoint responsible persons for this purpose.

EMIR

In accordance with Regulation of the European Parliament and of the Council (EU) No 648/2012 on OTC derivatives, central counterparties and trade repositories (EMIR), since February 2014 the Company is obliged to inform the European Securities and Markets Authority (ESMA), via the approved trade repositories, about any bilateral OTC transactions. To fulfil this obligation, LEG Wholesale Electricity Trade Department will notify the financial derivative instruments' transactions to a selected trade repository.

It is anticipated that when the directive on financial market instruments (MIFID II) comes into force, energy companies will be released from the duty to notify the OTC transactions to ESMA.

Lithuanian Legal Framework

In accordance with the Republic of Lithuania Law on Electricity adopted in 2012, the NCECP conducts a market research according to the set market research rules and fixes the selling prices for electricity/reserve power that are mandatory for a person having significant influence in the relevant market. It is anticipated that during the period covered by this Strategy the NCECP will regulate the prices of the system services provided by LEG to the transmission system operator.

The Law No XI-375 enacted by the Seimas of the Republic of Lithuania establishes that the Elektrėnai Complex under LEG control is a power plant of strategic importance, with the electricity generated there being indispensable to ensure both the security of power supply and the energy reserves, therefore, the EC operations are supported via the PIS mechanism. At present a study on improvement of the PIS scheme is being conducted; its aim is to reduce the share of the PIS fee in the electricity tariff rate. It is projected that subsidising of the EC units will remain throughout the period covered by the Strategy but its forms may change depending on the conclusions of the study and the EU regulatory requirements. In 2013, amendments to the Law on the Liquefied Natural Gas Terminal were approved, according to which LEG as a producer of subsidised electricity will be obliged to buy liquefied natural gas from the terminal on priority basis. Therefore, the quota allotted to EC in 2015 will be determined not only by the TSO needs and development in the regulatory environment but also by the obligation to buy the gas from the LNG terminal.Upon implementation of the biofuel-based thermal capacities' development, LEG will remain the main heat energy generating company in the Elektrėnai Region. It is anticipated that there will be no changes in the regulatory environment for heat generation and the NCECP will continue regulating the heat selling prices.

Environmental Protection

The Company's operations are influenced by the policy formulated by the European Union institutions and binding on the EU Member States, according to which the quotas of free tradable pollution allowances (TPAs) will be reduced for power plants and more stringent requirements for pollutants' concentrations will come into force.

Integrated Pollution Prevention and Control (IPPC)

In accordance with the Directive of the European Parliament and of the Council of 24 November 2010 No 2010/75/EU on industrial emissions (integrated pollution prevention and control), from 2016 all the EU Member States will be subject to more stringent requirements for all pollutants emitted from large combustion plants:

- allowable SO2 concentrations will be reduced about 2 times;
- allowable NOx concentrations will be reduced about 2.5 times;
- allowable CO concentrations in natural gas will be reduced 3 times;
- allowable solid particles' concentrations will be reduced 2.5 times.

As, according to the more stringent pollution requirements, the old combustion installations of the reserve power plant, which were installed in 1960–1972, cannot be operated after 2016 unless additional investments are made in them, the Company has undertaken to operate the pollution sources (stacks) No 001 (used for Units 1 and 2 of the plant), No 002 (Units 5 and 6) and No 003 (Units 7 and 8) maximum 17,500 hours each in the period from 1 January 2016 until 31 December 2023. In such a case the pollution limit values laid down in the aforesaid Directive 2010/75/EU would be applied to the reserve power plant only from 1 January 2024.

Tradable Pollution Allowances (TPAs)

In accordance with Directive of the European Parliament and of the Council of 13 October 2003 No 2003/87/EC establishing a scheme for greenhouse gas emission allowance trading, from 2013 no free tradable pollution allowances will be allotted to companies operating in the energy generation sector and the companies will have to buy the requisite TPAs at auctions.

As the Elektrėnai Complex met the criteria allowing to use the provisions set out in Article 10c (5) of the aforesaid Directive, by its Decision No C(2012)3237 of 23 May 2012 the European Commission approved the application submitted by the Republic of Lithuania on 5 October 2011 together with the National Investment Plan and agreed to allot free TPAs to energy generating installations, including EC, for the transitional period 2013-2019. The TPAs for the electricity generating facilities for 2013-2020 have not been allotted as yet.

The EC will receive free TPAs under Article 10a of Directive No 2003/87/EC which provides for the allocation of the MPPs in order to promote the reduction greenhouse gas emissions and the use of energy efficient technologies.

The Minister of the Environment and the Minister of the Economy of the Republic of Lithuania have approved the following quantities of free TPAs for the Elektrėnai Complex:

- 2013 – 31.148
- 2014 – 27.874
- 2015 – 24.694
- 2016 – 21.614
- 2017 – 18.630
- 2018 – 15.744
- 2019 – 12.950
- 2020 – 10.258

Having regard to the planned production volumes of the EC in the period until 2020, the number of TPAs available in 2014 and the number of free TPAs to be received by 2020, there will be no need for the LEG to acquire additional TPAs in the market.

Impact of significant market developments on LEG operations

The following trends in the development of electricity networks and trading markets are lately observed in Europe:

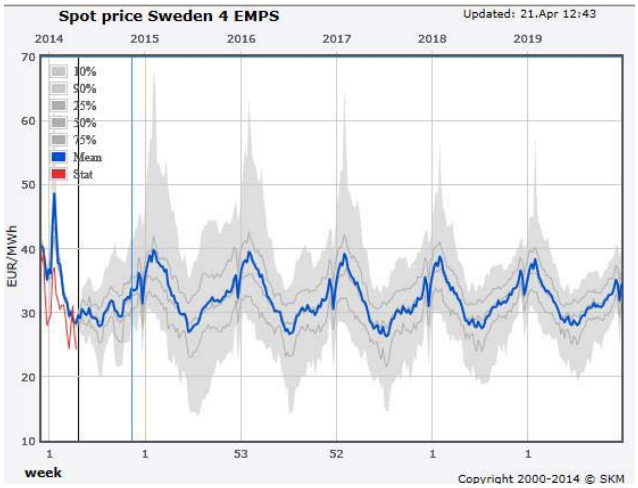
- The use of renewable energy sources is rapidly increasing in Europe, in particular the development of wind and solar energy farms, which leads to an increase in irregular electricity generation volumes and lowers the wholesale electricity prices.
- The RES development and the slow-down in economic growth of the EU has resulted in a significant drop in the prices of tradable pollution allowances. In order to reduce the excess quantities of TPAs, in 2014 the European Commission took 900,000 TPAs from circulation. They should be returned to the market by 2020. At present, development of a new TPA trading system, with mechanisms protecting against significant TPA price fluctuations, is under way.
- As the scope of extraction and use of shale gas in the energy system has been widening in the US, both the demand and prices for coal have dropped worldwide. The significant drop in coal prices, together with the lower prices for TPAs, have led a significant lowering of the cost of production at coal-fired power plants, therefore, they became much more competitive compared with gas-fired plants.
- Profit margins of gas-fired plants are negative in almost all European countries, therefore, even new and efficient gas-fired plants that should operate in market conditions are either put into prolonged storage or closed.
- The development of the RES and the lowering of prices for TPAs and coal have led to decrease in the average electricity price, which has significantly worsened the energy sector's investment environment. As pay-back periods cannot be determined, many new RES development projects are suspended or postponed.
- The European countries are increasingly realising the benefits of trans-boundary power links and supporting the power link development projects as they enable the diversification of electric power sources, ensuring energy security and making electricity prices uniform. At the beginning of 2014, the Nordic and Western European market's coupling too place. It is anticipated that the process of integration of national European electricity markets will continue.
- The process of linking the power transmission systems of the Baltic and Nordic states that was started in 2006 is expected to be completed by 2016:
  - Estlink-1 and Eslink-2 connecting the Finnish and Estonian energy systems have already been put into operation.
  - It is estimated that the construction of NordBalt, a 700 MW cable connecting Sweden and Lithuania, and LitPol Link 1, a 500 MW cable connecting Lithuania and Poland, will be completed by 2016.
  - By 2020, an additional 500-600 MW power link connecting Estonia and Latvia and a second 500 MW cable between Lithuania and Poland (LitPol Link 2) will be completed.

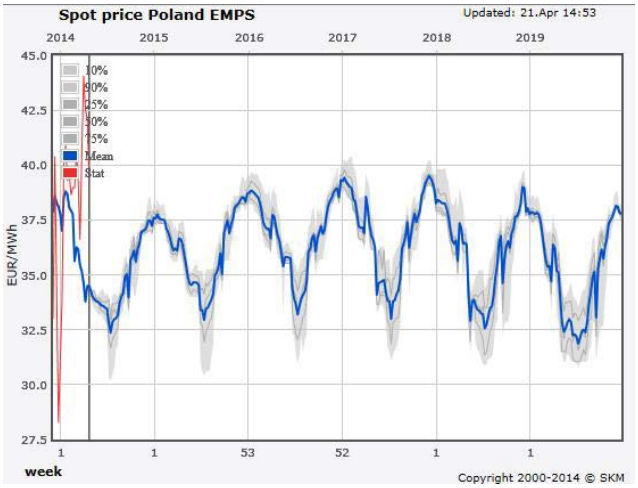
Figure 3
Map of existing and projected power links

Legend: – projected links (MW), – existing links (MW)

- Due to the linking of the power transmission systems and the integration of the electricity trading markets, prices for electricity should gradually become similar in the Baltic countries, Nordic countries and Poland (se Figure 4). Upon linking of several electricity markets together, prices of the larger markets will remain dominant (i. e. the prices in smaller markets will adjust towards the price levels in the larger ones), therefore, putting the power links with Sweden and Poland into operation should lead to a reduction of the Baltic States' prices to the current levels of the Nordic countries/Poland.

Figure 4
Electricity price projections



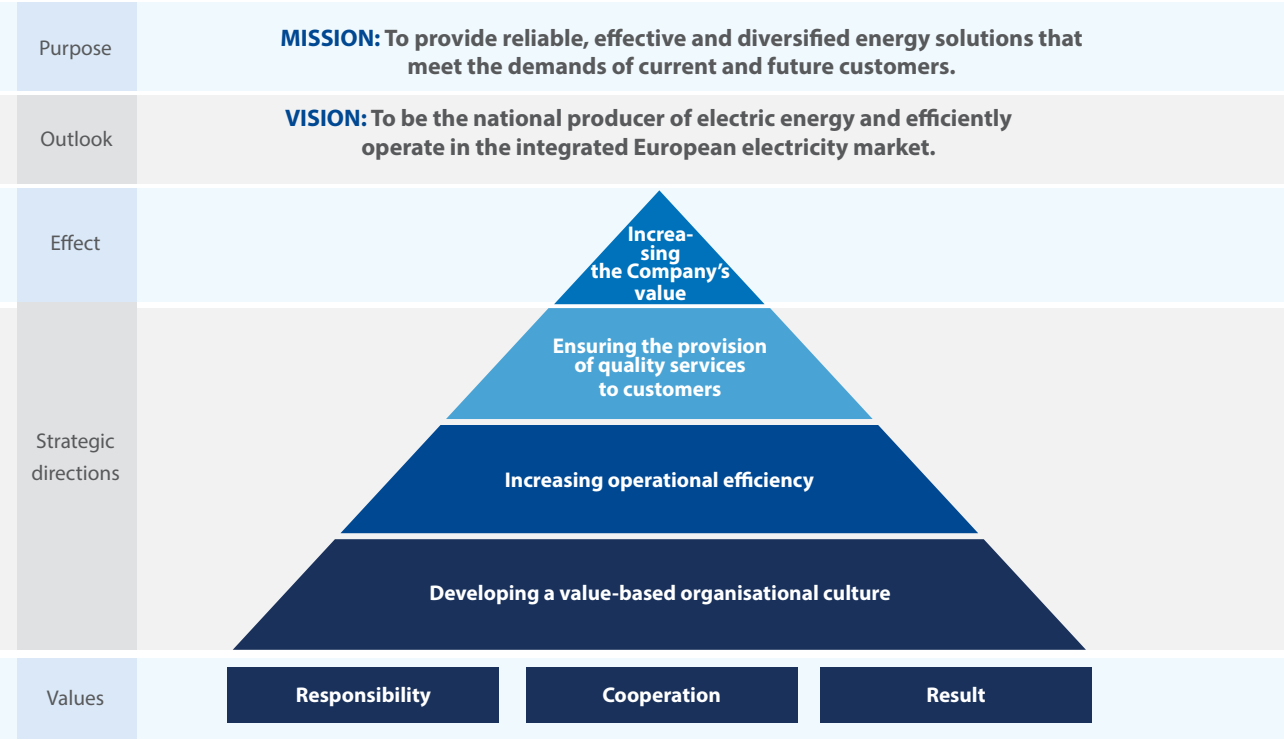


- While the influence of the Russian market on the Baltic States will decrease significantly upon putting NordBalt and LitPol Link 1 into operation, it is projected that Russia will continue exporting electricity to the Baltic States, with trade volumes probably smaller than in 2013-2014.
- Gas price fluctuations may be the most important factor affecting both electricity prices and volumes in Russia. While gas prices in Russia's domestic market tend to grow, at present the increase has been stopped by political decisions. Even considering a further growth in the gas prices, in the nearest years the average electricity price levels should not be much higher than the current ones (i. e. the average price for electricity should be EUR/MWh 25-40 depending on currency exchange fluctuations). It is forecast that due to emergence of new more effective generation sources in the market, in the period by 2017 the electricity prices in Russia should drop at the rate of 3-4 % per year. The main factor restricting imports from Russia is the 'power charge', which increases the prices offered by exporters of electricity from Russia by as much as 20 EUR/MWh during peak hours.

Strategic Directions and Objectives

Having regard to the values that are cornerstones of the LE Group, the mission of the Company and the results of the environment analysis, LEG is going to realise its vision and to organise its business activities along the four strategic directions (see Figure 5).

Figure 5
Strategic directions of LEG business activities



For each of the directions, strategic objectives have been formulated and indicators measuring their achievement have been identified (according to a methodology of balanced performance indicators). The accomplishment of the mission, the realisation of the vision, and LEG operations as a whole are based on the values formulated having regard to the Group's values.

A detailed action plan for the implementation of the strategy is structured according to individual strategic objectives and is prepared for a three-year period during which its implementation is continuously monitored.

Strategic Directions

Increasing the Company's value

LEG will seek to improve its profitability indicators and increase EBITDA in accordance with the objectives set by the Group. In this way the value of both the Company and the Group will be increased.

This will be achieved by consistently improving the profitability of commercial activities, abandoning those production capacities that are not in use, investing in the modernisation of other capacities, increasing efficiency of processes, and cutting operating costs. Subject to favourable market conditions, after 2016 LEG will decide on investments in the construction of Unit 5 of the Kruonis PSHP thus securing further augmentation of the Company's value after 2020.

Ensuring the provision of quality services to clients (TSO, suppliers, customers)

The aim of LEG is to serve its customers' interests by ensuring an optimal price and diminishing the dependence on the state subsidising (PIS). This is going to be achieved by abandoning part of the EC generation capacities that are maintained as a strategic reserve, through an effective electricity trading portfolio management, and balancing of the electricity generation and trading volumes. In addition, the Company will invest in the remaining EC capacities to ensure high availability of such capacities, thus contributing to the energy security.

In order to form an electricity portfolio that is in line with the wishes of electricity suppliers and to secure optimal electricity prices for both suppliers and end customers, LEG plans to develop the available competences in electricity trading. Using of all the available market mechanisms will be sought including the physical electricity trading through bilateral contracts or electricity exchange and the trading in various financial contracts (e. g. futures or contracts for differences), which provide protection against the electricity price fluctuations.

LEG as a socially responsible company will place emphasis on environmental protection in its operations. This will be realised both in the responsible conduct of current business activities and by cleaning up the past pollution.

Increasing operational efficiency

In order to increase efficiency of its operations, LEG focusses on the review and improvement of its business processes in both direct and auxiliary activities. The Company uses LEAN principles and tools in optimising its processes, having regard to best practices of Lithuanian and foreign generation companies. By implementing internal investment projects aimed at modernisation of production equipment, the Company will seek improvements in project management by building competences of its personnel, improving procedures, and developing the employee motivation system. The aim to complete works within the agreed time limits has been separated out as one of the most important aspects.

Having regard to the varying demand for the secondary, tertiary and strategic reserve, LEG will seek to optimise production capacities under its control, by abandoning those units which are not used in full. LEG's goal is to achieve profitability of all its power plants, without transferring the results of the successfully operating ones to the rest.

Developing a value-based organisational culture

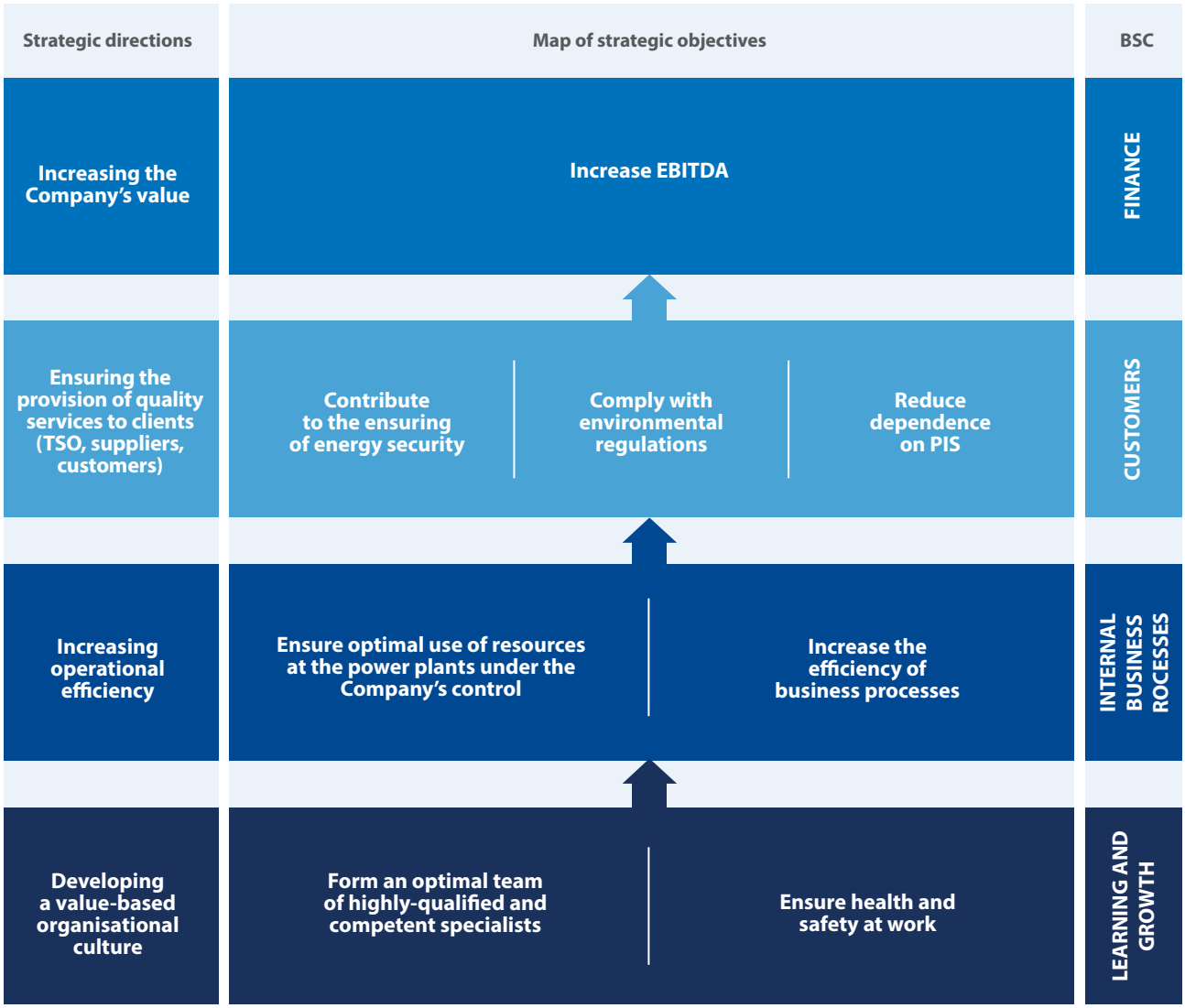
Taking guidance from the best practices of foreign energy companies, LEG seeks to develop a new organisational culture that is result-oriented and based on values, leadership, focussing on employees and increasing employee involvement in the Company's activities. In the development of the organisational culture, promoting the employee involvement is in the focus of attention; means and tools for increasing the employees' commitment to the corporate values and for directing them to the achievement of the corporate objectives are being developed. One of the main objectives is to achieve a low turnover of key personnel. Considering the older average age of the employees and frequent reorganisations of the energy sector, in order to maintain continuity of operations it is very important to secure replacement of the key employees and to train substituting personnel.

The Company places emphasis on the health and safety at work area. It seeks to effect a cultural change in this area, whereby health and safety at work is ensured not only by preventive measures but becomes an integral part of the organisational culture and employee behaviour.

Strategic Objectives

Long-term strategic objectives of LEG have been identified for each strategic line of business, based on the balances scorecard (BSC) methodology (see Figure 6).

Figure 6
LEG strategic objectives



All the strategic objectives contribute to the augmentation of the value of the Company and the return on assets, proper representation of the shareholders' interests, enhancing the Company's competitiveness and sustainable development.

Wholesale Electricity Trade and Generation

Optimising the Operations of Power Plants

The power plants under LEG's control will have to be used in the most efficient way after the power links with Sweden and Poland are put into operation, leading to a change in market conditions.

The start of the intraday trading in Lithuania in 2013 has enabled LEG to trade in electricity one hour prior to the operating hour. This means that the Company can use its generation sources in a more efficient manner and to sell electricity on more profitable terms. As profit margins in intraday trading are higher compared with the day ahead market, it is estimated that, in the future, increasing amounts of electricity will be traded real time and the trading will be continuous (i. e. 24/7).

Trading in Electricity Price Fluctuation Hedging Products and Other Services

As the shareholder's expectations with respect to LEG's financial return are ambitious, the Company intends to both optimise the power plant operations and ensure a better use of the available electricity trading competences. While ensuring that the risks assumed are reasonable, the Company will seek to benefit from the sale of the electricity price fluctuation hedges to Energijos Tiekimas UAB or other market participants as well as from speculation trading where electricity is bought at fixed prices and sold at variable prices or vice versa.

In order to increase the opportunities for protecting itself against electricity price fluctuations on NPS exchange and to be able to engage in speculation trading, in 2014 LEG will become a member of NASDAQ OMX Commodities and start trading in listed financial derivative instruments. While the scope of speculation trading in the derivatives in 2014-2015 is expected to be small, it should increase considerably in 2016. It is estimated that starting from 2016-2017 the Company will be trading not only in electricity but also in such new products as options, spark spreads, dark spreads, price zone spreads, various indexes and TPAs.

System Services

According to projections, the demand for system services should grow in 2014-2020 due to the completed power links with Poland and Sweden and the development of RES.

It is estimated that upon completion of NordBalt and LitPol Link 1, the demand for the secondary reserve will reach 400 MW/h and that for tertiary reserve 600 MW/h in 2016.

It is also projected that, upon increase of the wind farms' installed capacity to 500 MW, there will be an increasing demand for flexible electricity generating capacities to balance the wind farm production deviations, therefore, the demand for the regulating services provided by LEG should gradually grow in the period by 2020. Still, accurate year-by-year projections of regulation volumes are practically impossible due to their instability.

As regards the reactive power control and system recovery services provided by LEG, no significant changes are anticipated by 2020.

Table 1

Projected sales of power reserving services at LEG sources

Average power reserve (MW/h)	2014	2015	2016	2017	2018	2019	2020
Reserve power plant + CCU	270	270	600	600	600	600	600
Kruonis PSHP	200	200	400	400	400	400	400

Use of the capacities of Elektrėnai Complex

In recent years, production volumes at Elektrėnai Complex have been decreasing. It is estimated that the lowering trend will remain due to stronger marker competition and the transition to the new thermal energy generation capacities. The main current trends are as follows:

- **Non-competitive generation cost.** The electricity generating units of EC that are fired by gas and fuel oil cannot be competitive under current market conditions. It is estimated that the putting of the power links with Sweden and Poland into operation should not lead to an increase in the electricity prices and, on the contrary, it is possible that they will become lower. Whereas there are no grounds for expecting a considerable decrease in the EC production cost as, according to projections, the gas and fuel oil price levels should remain more or less the same. At present, the only competitive types of power generation in Europe are the nuclear and hydroelectric power plants (due to low variable

production costs), power plants using RES (due to low variable production costs and high subsidising) and coal-fired power plants (due to low prices for coal and TPAs).

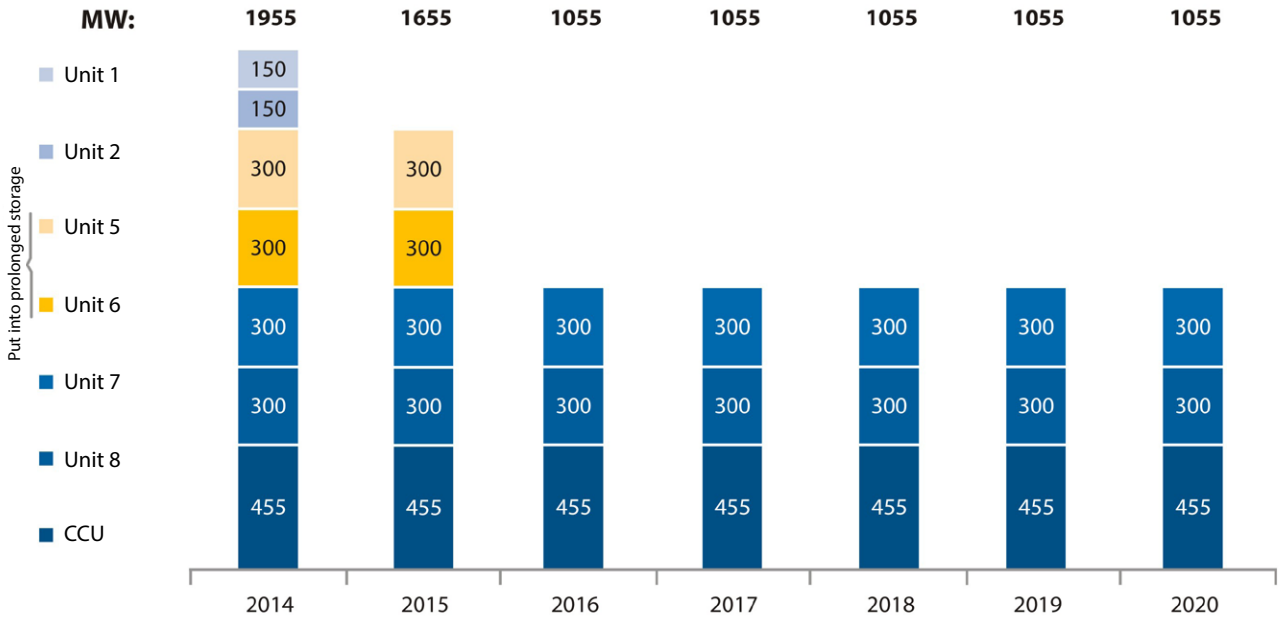
- **Expansion of the market for system services.** Litgrid, the Lithuanian electricity transmission system operator, and its partners in the region analyse the opportunities and search for ways to reduce the costs of system services. With this aim in view, the operators are reviewing the demand for reserves in the region as well as the opportunities for acquiring them. Furthermore, after the power links with Sweden and Poland become operative at the beginning of 2016, it will be possible to buy other system services (such as regulation within a narrow range (+- 25 MW) through these links, therefore, EC will face competition in a much wider market.
- **Replacement of old production capacities.** The first biofuel-fired thermal installations should be launched at Elektrėnai in the 2014-2015 heating season. They will replace the two outdated 150 MW units (built in 1962-1965) that are still in use (Unit 1 and Unit 2). No major investments were made in these units during the past five years in order to prolong the service life of the units, with just necessary maintenance works carried out on them.

In view of the foregoing, the number of units operating at EC should be reduced (see Figure 7). Units 1 – 6 will be gradually removed from operation and dismantled.

- As Unit 1 and Unit 2 are mainly used for the generation of heat energy, their dismantling will be started immediately after the completion of construction of the new thermal energy capacities at the end of 2014. The estimated start of dismantling works: 2015.
- Unit 5 and Unit 6 should be put into prolonged storage until the end of 2015, when the demand for reserves in the region should be known, after the completion of the power links with Sweden and Poland. For the time being, after 2016 Litgrid is not planning to order a tertiary reserve in excess of 500-700 MW (according to information provided by Litgrid, it is probable that the tertiary reserve purchased from EC will amount to 500 MW (best-case scenario: 700 MW), therefore, the tertiary reserve could be fully covered by Unit 7, Unit 8 and CCU. Based on these assumptions, final decisions on the dismantling of Unit 5 and Unit 6 after 2016 will be adopted in 2015.

Equipment and systems common for all transformer substations will be optimised along with the dismantling of the units, which will lead to the cutting of the EC's fixed costs. As the average age of the EC servicing personnel is quite high, the personnel numbers will be naturally decreasing, with gradual retirement of people. In order to maintain the Company's production competences, training of substitutes for the key personnel will take place. If necessary, requalification training will be held, universal competence promoting programmes will be implemented and internal (Company and Group) rotation opportunities will be sought due to the shrinking of production volumes. In such circumstances, the Company will strive for social justice to the maximum extent possible; all social guarantees will be applied including the timely and transparent communication and consultations with trade unions.

Figure 7
Use of EC capacities



In the long term, the following units will be operative at the EC: a modern 455 MW combined-cycle unit and Unit 7 and Unit 8, 300 MW each, fired by fuel oil and operating in compliance with the EU pollution regulations. The total EC capacity would be 1055 MW of power.

LEG Financial Forecasts for 2014–2020

The forecasts of key financial indicators of LEG for 2014-2020 have been made based on the defined strategic directions of business and having regard to the most probable scenario, which was formulated according to the planned factors of both external and internal environment and the estimated values of the assumptions that affect the LEG's operations.

Due to confidentiality considerations these forecasts are not included in this Summary of the Strategy.

Investment Projects that the Company Plans to Implement by 2020

Investment projects included in the LEG strategy:

- New heat generation capacities in Elektrėnai (40 MW biofuel-fired boilers and a 50 MW gas-fired steam boilers);
- Subject to favourable market conditions – the Kruonis PSHP development with the installation of the fifth hydro unit (225 MW;
- In case if the decision to invest in the construction of the Kruonis PSHP Unit 5 is adopted, the total investment requirement for the development projects would be LTL 450 - 650 million;
- LEB will have the opportunity to implement additional investment projects in 2017–2020.

Investment projects planned by LEG for 2014–2020 are listed in Table 2.

Table 2
Investment projects planned by LEG

Item No	Description	Investments	Implementation timeframe	Benefits
1	Biofuel-fired heat generation plant at Elektrėnai Complex (40 MW biofuel boilers and 50 MW gas stem boilers) Putting into operation: end of 2014	LTL 95 m	2013-2014	• Upon completion of the project, the electricity generation and the heat generation will be independent operations at EC, with production volumes depending on estimated consumption. • Upon completion of the project, a large part of natural gas necessary for the production process will be replaced with biofuel. • EC operations will become more competitive. • The capacity of the new EC biofuel-fired boilers will be 40 MW of power. With the heat produced at these boilers and using local fuel, 90% of the demand of Elektrėnai town would be satisfied. During the cold period of the year when the demand for heat increases, gas-fired steam boilers will be used, which will ensure a reserve for the biofuel boilers as the man production capacities. Gas-fired boilers will also be required for the functioning of the process equipment of the power plant and for the start-up of the EC's reserve units if necessary.
2	Kruonis PSHP development 225 MW	LTL 385-550 m	2017–2020	• The main purpose of the investments is to ensure stable operating conditions of the electric power system, enabling an increase in the power of the connected wind farms in both domestic and neighbouring markets. • Obtaining potential revenues from electric power transformation and regulation due to increased efficiency and flexibility of the new capacities. • Securing the power reserve in case of construction of the new nuclear power plant.

The sequence of the projects' implementation is subject to change depending on the market developments.

Apart from these main investment projects, LEG intends to make other investments necessary for the proper and effective operations of the Company.

A wind farm is another potential development project considered by LEG. Potential benefits of the project are as follows:

- Development of the green energy generation capacities in Lithuania using renewable energy sources and thus reducing Lithuania's dependence on electricity imports;
- Increased flexibility of system services offered by LEG and stronger potential of revenues from such services, making use of and combining the advantages of various production capacities available.

It is estimated that investments within the range of LTL 180 – 200 million would be required for the wind farms. Wind parameter measurements will be carried out in the territory of the Kruonis PSHP until the beginning of 2015. Based on the measurement results, further course and prospects of the project will be considered. Due to high uncertainly related to the implementation of this project, the wind farm project has not been included in LEG's long-term financial model and its results are not reflected in the financial projections.

STRATEGY IMPLEMENTATION MONITORING PRINCIPLES

- The LEG Strategy will be updated in case of significant developments in the legal environment or other material events in the energy sector.
- The assumptions underlying the Strategy are used in the formulation of the LEG Operating Plan, the results of which are presented to the Board on a quarterly basis, and the drawing up of LEG's annual budget.

The long-term strategy is reviewed and, if necessary, updated in Quarter II of the current year having regard to changes in the National Energy Strategy (NEG), amendments to relevant laws, significant events in both domestic and foreign electricity markets, and changes in the external circumstances which have not been taken into account at the time of the Strategy's formulation or which are beyond control of the Company.

The long-term strategy forms the basis for the preparation of a detailed operating plan and the budget for next year, which are approved by the Board of the Company.

Monitoring of the Company's Operating Plan will be conducted upon the end of each quarter, 6-month period and year, in order to assess the results achieved by the Company. The monitoring will include an assessment of the strategic objectives' consistency with the Operating Plan, the implementation of the Operating Plan, and the employees' performance.

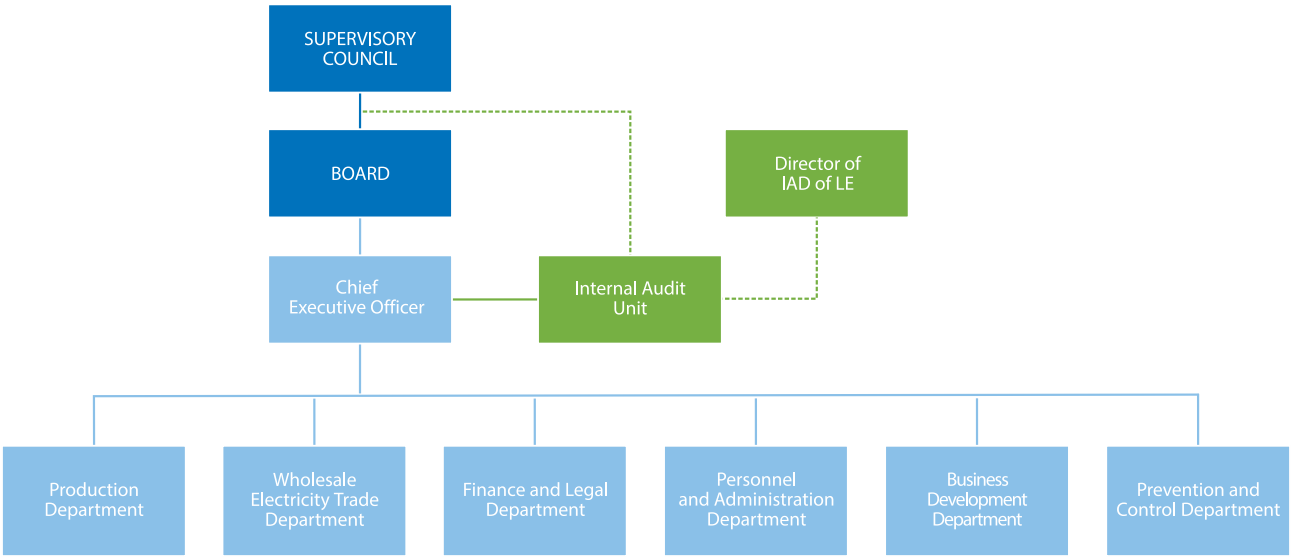
The measures provided in the Operating Plan will be included in the individual employee performance assessment plans; the variable part of the employee's pay will be set on the basis of performance.

In the period of implementation of the Strategy, risks that may affect the successful realisation of the Strategy will be monitored and risk reduction actions will be planned.

Annex 1. System Services

- **Power reserving service.** This service is a means to secure reliable operations of the energy system when, in cases of contingencies, the generation of electricity decreases or its consumption increases. Power generating companies provide the service of maintaining the secondary and the tertiary power reserves. A secondary active power reserve is the power of installations or hydro units maintained by the company and activated within 15 minutes. A tertiary active power reserve is the power of generating sources maintained by the company and activated within 12 hours. The secondary power reserve is secured by the Kaunas HPP and the Kruonis PSHP and the tertiary reserve is secured by the EC. In 2013, the Company sold approx. 1.75 TWh of the secondary reserve and approx. 2.31 TWh of the tertiary reserve (2012: 2.02 TWh and 2.69 TWh respectively).
- **Regulating power service.** The service is required for the balancing of the electricity surplus and the electricity deficit in the energy system. Trading in regulating power takes place in real time, securing the reliable operation of the energy system each hour. When there is a shortage of electricity in the system and the TSO gives an instruction to increase its generation, the Company increases the electricity generation volumes and sells the lacking regulating electricity to the TSO. In case of surplus electricity in the system, the TSO instructs the Company reduce the generation and the Company then purchases the surplus regulating electricity from the TSO. In 2013, the Company sold 0.86 TWh and bought 0.03 TWh of regulating electricity (2012: 0.03 TWh and 0.03 TWh respectively).
- **Balancing power service.** This is the actual deviation from the estimated electricity generation/consumption schedule presented by the TSO. Trading in balancing electricity takes place after the end of each reporting month; it encourages the market participants to accurately forecast their electricity generation and consumption volumes. For example, if, during a certain hour, the Company produced a smaller amount of electricity than planned, it must buy the difference from the TSO (a purchase of balancing electricity) and, vice versa, if the amount of electricity produced during an hour is larger than planned, the Company has to sell the difference to the TSO (a sale of balancing electricity).
- **Reactive power management service.** A system service the purpose of which is to level an unevenness in the loads of the energy system and to ensure the requisite voltage and frequency levels. The reactive power management service is provided by the Kruonis PSHP's units operating in the synchronous condenser mode.
- **Service of system recovery upon total emergency.** This is the readiness to quickly start up a generating source without using power supply from the grid in cases of full or partial failure of the power system. The service of the system recovery in case of total emergency is provided by both Kruonis PSHP and Kaunas HPP.

Annex 2. Structure of the Company



Annex 3. Abbreviations and Terms

Abbreviation	Explanation
ACER	Agency for the Cooperation of Energy Regulators
CCP	Central counterparty
CCU	Combined-cycle unit
CEG	Continental European Grid
EBITDA	Earnings before interest, taxes, depreciation and amortisation
EC	Elektrėnai Complex
EMIR	European Markets Infrastructure Regulation
ESMA	European Securities and Markets Authority
EU	European Union
Group	Lietuvos Energija, UAB Group of Companies
HPP	Hydroelectric power plant
IPPC	Integrated pollution prevention and control
Kaunas HPP	Kaunas hydroelectric power plant
Kruonis PSHP	Kruonis pumped storage hydroelectric plant
LE	Lietuvos Energija, UAB
LEG, Company	Lietuvos Energijos Gamyba, AB
Litgrid	Litgrid AB, the Lithuanian transmission system operator
LNG	Liquefied natural gas
NCECP, Regulator	National Commission for Energy Control and Prices
PIS	Public interest services
PSHP	Pumped storage hydroelectric plant
REMIT	Regulation on Wholesale Energy Market Integrity and Transparency
RES	Renewable energy sources
ROE	Return on equity
Secondary/tertiary reserve	Reserve purchased by Litgrid
Strategic EC reserve	Reserve supported from PIS fund
Strategy	LEG Business Strategy – this document.
SWOT analysis	Analysis of strengths, weaknesses, threats and opportunities
TPA	Tradable pollution allowance (an allowance to emit one tonne of carbon dioxide equivalent during a specified period)
TSO	Transmission system operator

Lietuvos Energijos Gamyba, AB
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2014