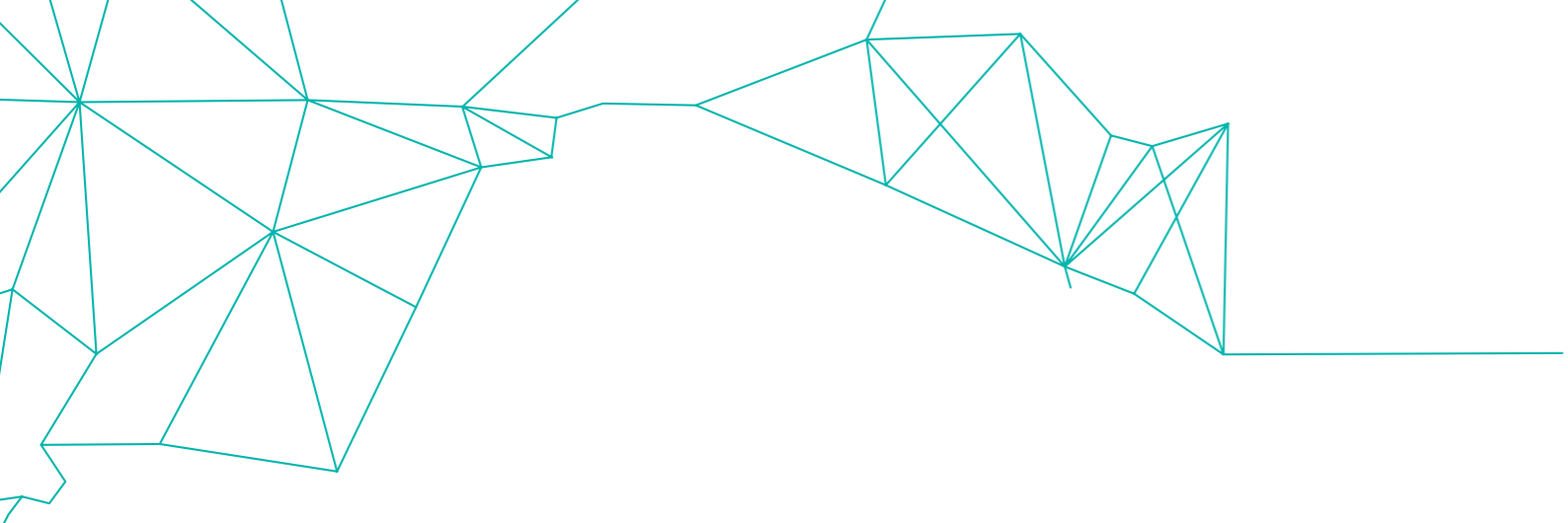




Corporate Governance Report





In 2016, the Management Board of Elering approved the updated Corporate Governance Code¹. This code is a set of recommendations that are meant to be followed mainly by stock exchange companies.

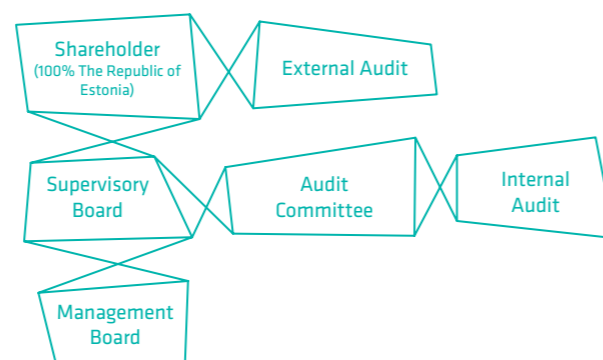
Elering is dedicated to following the Corporate Governance Code and wishes to grow further in this area. We consider this a prerequisite for achieving our strategic goals and shaping our organisational culture.

We can confirm that:

- the company's risk management and control systems are fully functional and efficient; and
- the company's financial reporting and annual report are based on a functioning system of risk management and internal control.

Elering publishes the Corporate Governance Code and its Corporate Governance Report on its website www.elering.ee.

Shareholder rights



100% of the shares in Elering are owned by the Republic of Estonia.

The shareholder is represented at the general meeting by the Minister of Economic Affairs and Infrastructure. The general meeting of shareholders is the highest governing body of Elering. The general meeting for 2016 was held on April 26. No extraordinary general meetings were convened by the Management Board. The general meeting was attended by Minister of Economic Affairs and Infrastructure Kristen Michal; Supervisory Board chairman Kajar Lember; Management Board members Taavi Veskimägi, Peep Soone and Kalle Kilk; and Ministry of Economic Affairs and Communications officials Ando Leppiman, Timo Tatar, Priit Tinitis, Kätlin Atonen and Regina Raukas.

At the meeting, decisions were made with regard to approving the annual report for 2015, paying out dividends and distributing retained profits.

The competence of the company's owner includes: amending the articles of association; increasing and decreasing share capital; electing and removing members of the Supervisory Board; electing auditors; appointing a special audit; approving the annual report and allocating profits; and deciding upon the merger, division, restructuring and/or dissolution of the company. The general meeting must base its actions (convening, disclosure of information, etc.) on the State Assets Act and the Commercial Code.

Management Board

The Management Board is Elering's governing body. It represents and governs the company's daily activities in accordance with the law and the requirements of the organisation's articles of association, and organises the company's accounting. Elering's Management Board has complete freedom of decision: everyday management choices are made independently, without interference from the owner or the Supervisory Board. The Management Board needs the consent of the Supervisory Board for transactions and operations that are beyond the daily economic activities of the company. The Management Board ensures that the members of the Supervisory Board have sufficient information regarding the company's economic situation, as well as important circumstances related to economic activities, and informs the Supervisory Board of important circumstances related to economic activities as necessary.

Composition and remuneration of the Management Board

According to the articles of association, the Management Board can consist of up to three members. The Supervisory Board elects members of the Management Board for a term of up to five years. The company's articles of association state that two members jointly or the Chairman of the Management Board separately can represent the company in all legal transactions.

The person authorised by the Supervisory Board enters into contracts with the members of the Management Board which determine the rights and obligations of the Management Board member regarding the company and their remuneration.

Throughout 2016, the Management Board of Elering comprised three members:

- Taavi Veskimägi – Chairman of the Management Board. His responsibilities include the day-to-day duties of the Chief Executive Officer of Elering, i.e. management and representation of the company, ensuring compliance with contracts and legislation, organising the work of the Management Board, coordination of the development of the company's strategy and performance of a leadership role in the implementation of this strategy.
- Peep Soone – Member of the Management Board. His responsibilities include the position of Chief Financial Officer, managing the accounting and finance of Elering.
- Kalle Kilk – Member of the Management Board. His responsibilities include day-to-day duties as the Head of Asset Management.

Based on the articles of association, a member of the Management Board may only be paid a fee under the contract entered into with them. A member of the Management Board may also be paid an additional fee based on their performance in the amount of up to four months' fee. Bonuses may be paid based on the annual results or any other grounds on the basis of a resolution of the Supervisory Board. The fees of the members of the Management Board are fixed and stipulated in the Management Board member's contract. Elering has not established any long-term bonus systems. A member of the Management Board may only be paid severance benefits upon their removal at the initiative of the Supervisory Board before the term of their authority has expired in the amount of up to three months' fees.

Elering does not disclose the pay of members of the Management Board individually due to the confidentiality provisions contained in their contracts. Instead it discloses the total remuneration of governing bodies (including taxes) in the company's annual report. The remuneration paid to the members of the Management Boards of Elering AS in 2016 was EUR 485 thousand (incl. social taxes).

¹ The Corporate Governance Code initiated by Tallinn Stock Exchange and the Financial Supervision Authority was released in 2015.

Conflicts of interest

Members of the Management Board do not make decisions based on their own interests, nor do they use commercial offers made to Elering to their own gain. A member of the Management Board must declare any conflict of interest to the Supervisory Board and other members of the Management Board before entering into their contract of service, or as soon as such a conflict arises. A member of the Management Board must promptly notify other members of the Management Board and the chairman of the Supervisory Board about any commercial offers related to the company's economic activities made to them, their family members or anyone else associated with them.

The principles preventing conflicts of interest of members of the Management Board are established in the contracts entered into with them.

A member of the Management Board avoids conflicts between their own interests and the interests of the company. He or she declares any direct or indirect interest in the transactions made by the company to Elering's Supervisory Board, informing it of any conflict as soon as it arises or of any situation that could lead to such a conflict. The Supervisory Board decides upon executing transactions with members of the Management Board or any transactions that could involve the personal interests of members of the Management Board. They also decide upon the terms and conditions of the transaction.

In order to ensure independence, transactions entered into with related parties are declared upon the approval of the annual report and in the audit.

Elering did not enter into any transactions with members of the Management Board or related parties in 2016.

Supervisory Board

The owner's interests in the company are guaranteed by the members of the Supervisory Board (representatives of the Ministry of Finance and the Ministry of Economic Affairs and Communications). The Supervisory Board gives the Management Board instructions on organising the management of the company and exercises supervision over the activities of the company's Management Board. The Supervisory Board regularly reviews and assesses the company's strategy, general actions, risk assessments, annual report and annual budget.

According to the company's articles of association, regular meetings of the Supervisory Board are held as needed, but no less frequently than once every three months. The notification of a Supervisory Board meeting and any related materials are sent to the board members at least three working days before the meeting takes place.

Composition and remuneration of the Supervisory Board

The Supervisory Board comprises three to five members. The number of members is decided and the members are elected and removed by the representative of the owner, i.e. the Minister of Economic Affairs and Infrastructure. The work of the Supervisory Board is run by a chairman, who sets the agenda for Supervisory Board meetings, runs the meetings, observes the effectiveness of the Supervisory Board's actions, arranges operational data transfers to Supervisory Board members, provides enough time for the members to draft decisions and familiarise themselves with the data and represents the Supervisory Board in interactions with Elering's Management Board. To coordinate the Supervisory Board's work, the general meeting has established the Supervisory Board's working procedures.

In 2016 the Supervisory Board held four regular meetings:

- April 6: Approval of annual report, approval of Supervisory Board report, overview of performance of core activities, transactions involving registered assets, change in members of Audit Committee
- June 8: Overview of four-month financial results, overview of general meetings, transactions involving registered assets, election of Chairman of Supervisory Board, change in members of Audit Committee
- September 28: Overview of eight-month financial results, approval of Elering strategy and risk assessments, transactions involving registered assets, change in members of Audit Committee
- December 19: Approval of operating budget and capital expenditure budget, overview of ten-month financial results, transactions involving registered assets, changes in members of Audit Committee

In 2016, the following persons were members of the Supervisory Board of Elering:

- Kajar Lember (politician) – Chairman of the Supervisory Board until May 30: attended one meeting;
- Timo Tatar (Head of the Energy Department, Ministry of Economic Affairs and Infrastructure) – Chairman of the Supervisory Board from June 8: attended four meetings;
- Priit Alamäe (entrepreneur), until February 17: attended no meetings;
- Thomas Auväart (Head of the Financial Markets Department, Ministry of Finance): attended four meetings;
- Indrek Kasela (entrepreneur), from August 21: attended 2 meetings;
- Tarmo Mänd (politician), until December 15: attended 3 meetings;
- Ando Leppiman (Deputy Secretary General for Energy and Construction, Ministry of Economic Affairs and Infrastructure), from December 15: attended 1 meeting.

The remuneration paid to the members of the Supervisory Board of Elering AS in 2016 was EUR 28 thousand (incl. social taxes). This remuneration includes payment for participation in the work of the audit committee. There is no provision for the payment of severance benefits or other benefits to members of the Supervisory Board.

Members of the Supervisory Board must meet the requirements set for Supervisory Board members in the Commercial Code, as well as in the State Assets Act, and they must meet all of their obligations.

Audit committee

The Supervisory Board elects the Audit Committee, comprising up to five members. The committee is responsible for exercising supervision over risk management, internal control and financial reporting. The committee advises the Supervisory Board in the area of accounting, checking the independence of the

statutory auditor, risk management, internal control and audit, exercising supervision and preparation of the budget as well as the legality of activities.

Members of the Audit Committee are elected for a term of three years. They elect from among themselves a chairman to organise the activities of the committee. The chairman cannot also hold the position of Chairman of the Supervisory Board. The members of the Audit Committee are paid a fee for participating in the committee's activities. The members of the committee are the members of the Supervisory Board of Elering.

In 2016 the Audit Committee met four times: on April 6, June 8, September 28 and December 19. The committee addressed the following internal audits that were carried out: electricity balance management audit; financial risk management audit; audit of employees workload engaged in administration of natural gas transmission network; and risk management audit.

Cooperation between Management and Supervisory Boards

The Management Board and the Supervisory Board cooperate closely to best protect Elering's interests. They work together to develop the company's strategy. The Management Board bases its management decisions on the strategic guidelines issued by the Supervisory Board.

The Management Board regularly informs the Supervisory Board of any important matters that have a bearing on the planning and business activities of the company and draws particular attention to important changes in Elering's business activities. The Management Board forwards data to the Supervisory Board, including financial reports, in sufficient time prior to Supervisory Board meetings. If the Supervisory Board requires more information about the operations of the Management Board or the company, a member of the Management Board provides the necessary data either verbally or in writing. They also ensure the Supervisory Board's access to any data relevant to the actions of the Management Board and the company.

The company's management principles are based on legislation, the articles of association and decisions made and objectives set at general meetings and Supervisory Board meetings.

Disclosure of information

Elering's website (www.elering.ee) presents a separate list of data that is subject to disclosure by law. The website presents annual reports, financial results, operating information, an overview of main activities, Elering's structure, a summary of its strategy, news and notices as well as other information needed by investors and the public. The website is also available in English. The information on the website is constantly updated.

Financial reporting and auditing

The Management Board of Elering publishes an annual report once a year and mid-term reviews during the financial year. The annual report is compiled in accordance with the International Financial Reporting Standards (IFRS) and is audited according to International Standards on Auditing (ISA). At the invitation of the Supervisory Board, the auditor of the company also participates in the meeting of the Supervisory Board to review the annual report. The annual report signed by the Management Board members is submitted to the general meeting for approval. Along with the annual report, the Supervisory Board's opinion on the annual report is submitted to the general meeting.

Elering elects an external auditor following procurement procedures and ensures the best possible value for money for the auditing services. Only internationally recognised, high-quality service providers are asked to submit a tender.

An external auditor is appointed upon the resolution of the general meeting, while the contract for auditing services is entered into by the Management Board. In the contract entered into with the auditor, his or her tasks, timeframe and fees are settled. This contract can in no way hamper the auditor's work in assessing the company's activities.

From 2012-2016 Elering's external auditor was AS PricewaterhouseCoopers. A new tender for the appointment of an auditor shall be held in spring 2017. The company is guided by the legislation of the Republic of Estonia, the ISA and auditor risk management regulations in performing external audits, including the Directive of the European Commission related to the field of audit that came into force in 2016.

The Audit Committee monitors the external auditor's progress in accordance with the Auditors Activities Act.

Risk management and internal control system

Elering's risk management is in compliance with ERM (Enterprise Risk Management) principles. Risk management objectives in Elering are as follows:

- to manage and describe the risk management processes in the company;
- to define the roles and responsibilities of the parties to the risk management process;
- to ensure that all risks are identifiable, assessable and able to be responded to; and
- to help managers better understand and manage risks.

The principles of the risk management policy in Elering must ensure that:

- the culture, processes and structure of the company encourage the fulfilment of the company's strategic objectives and at the same time the identification, management, monitoring and, if possible, hedging of risks;
- the monitoring and management of the company's risks and the internal control system are based on the internationally recognised Enterprise Risk Management (ERM) Model developed by the Committee of Sponsoring Organizations of the Treadway Commission (COSO), a voluntary organisation that promotes good corporate governance;
- all relevant legislation, standards, regulations, equal treatment and contractual obligations, as well as requirements and expectations arising from society, are taken into account in the management of the company's risks; and
- we continuously improve the risk management activities in the company.

The Management Board is responsible for the functioning of the internal control system of the company. To ensure the functioning of the system, the internal auditor service is outsourced to an audit company. The internal auditor reports to the Audit Committee.

From 2014-2016, internal audit services were provided to the company by KPMG Baltics OÜ. As a result of a tender held in 2016, KPMG Baltics OÜ, the bidder who offered the lowest price, will provide the service of internal audit to Elering for the next three years. The company is guided by the legislation of the Republic of Estonia and guidance issued by the Institute of Internal Auditors (IIA) in performing the internal audit function, including the Directive of the European Commission related to the field of audit that came into force in 2016.

The internal audit represents an independent and objective action that is designed to provide security and advice, add value to the actions of the company and improve it. This helps the company achieve its goals by using a systematic and orderly approach to assessing and improving risk management and the effectiveness of control and management processes. The function of the internal audit, which is independent from the areas being assessed, is to report to the Audit Committee of the company.

Equal treatment

As a system operator, Elering bears responsibility for the system in accordance with the Electricity Market Act. This means the obligation to ensure, at all times, the security of supply and the balance of the electrical system. The system operator exercises these rights and performs these obligations in compliance with the principles of equal treatment.

In order to ensure equal treatment, Elering has established internal procedures and, based on the legislation of the Republic of Estonia and of the European Union (including network codes), has compiled various standards, conditions, methodologies and other rules that have been published on the company's website and approved by the Estonian Competition Authority.