

MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

The following discussion and analysis of financial condition and results of operations should be read in conjunction with the unaudited consolidated interim condensed financial information for the six months ended June 30, 2016. This consolidated interim condensed financial information is prepared in accordance with International Accounting Standard 34 Interim Financial Reporting. The consolidated interim condensed financial information for the six months ended June 30, 2016 should be read in conjunction with the consolidated financial statements for the year ended December 31, 2015 prepared in accordance with International Financial Reporting Standards ("IFRS").

OVERVIEW

We are one of the world's largest gas and oil companies in terms of reserves, market capitalization and production. Our revenues are primarily derived from sales of natural gas, crude oil and other hydrocarbon products to Western and Central Europe, the Russian Federation and other Former Soviet Union countries.

We divide our operations into the following principal activities:

- Production of gas – exploration and production of gas;
- Transportation – transportation of gas;
- Distribution of gas – sales of gas within the Russian Federation and abroad;
- Gas storage – storage of extracted and purchased gas in underground gas storages;
- Production of crude oil and gas condensate – exploration and production of oil and gas condensate, sales of crude oil and gas condensate;
- Refining – processing of oil, gas condensate and other hydrocarbons, and sales of refined products;
- Electric and heat energy generation and sales.

Other activities primarily comprise production of other products and sales of various goods, works, and services.

Our main operating segments are mutually dependent, with a significant portion of the revenues of one segment comprising a part of the costs of another segment. In particular, the Distribution of gas segment purchases natural gas from the Production of gas segment and transportation services from the Transportation segment. The Refining segment purchases gas from the Production of gas segment and crude oil and gas condensate from the Production of crude oil and gas condensate segment. We establish internal transfer prices with reference to the specific funding requirements of the individual subsidiaries within each segment. Accordingly, the results of operations of these segments on a stand-alone basis do not necessarily represent each segment's underlying financial position and results of operations as if it were a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

RESULTS OF OPERATION

(RUB million)

	Six months ended June 30,	
	2016	2015
Sales	3,064,372	2,913,452
Net gain (loss) from trading activity	29,529	(7,953)
Operating expenses	<u>(2,680,732)</u>	<u>(2,224,215)</u>
Operating profit	413,169	681,284
Finance income	700,268	1,063,303
Finance expense	(367,387)	(949,422)
Share of net income of associates and joint ventures	33,766	61,415
Gains on disposal of available-for-sale financial assets	<u>1,021</u>	<u>430</u>
Profit before profit tax	780,837	857,010
Current profit tax expense	(105,785)	(122,538)
Deferred profit tax expense	<u>(49,647)</u>	<u>(43,216)</u>
Profit tax expense	(155,432)	(165,754)
Profit for the period	625,405	691,256
Other comprehensive income (loss):		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(78,625)</u>	<u>(118,428)</u>
Total items that will not be reclassified to profit or loss	(78,625)	(118,428)
Items that will be reclassified subsequently to profit or loss:		
Gains arising from change in fair value of available-for-sale financial assets, net of tax	20,806	38,783
Share of other comprehensive (loss) income of associates and joint ventures	(4,518)	11,619
Translation differences	(186,490)	(68,945)
Gains from cash flow hedges, net of tax	<u>39,535</u>	<u>13,478</u>
Total items that may be reclassified subsequently to profit or loss	(130,667)	(5,065)
Other comprehensive loss for the period, net of tax	(209,292)	(123,493)
Total comprehensive income for the period	416,113	567,763
Profit for the period attributable to:		
Owners of PJSC Gazprom	607,160	675,904
Non-controlling interest	<u>18,245</u>	<u>15,352</u>
	625,405	691,256
Total comprehensive income for the period attributable to:		
Owners of PJSC Gazprom	405,536	557,002
Non-controlling interest	<u>10,577</u>	<u>10,761</u>
	416,113	567,763

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Six months ended June 30,	
	2016	2015
Sales of gas		
<i>Europe and Other countries</i>		
Gross sales ⁽¹⁾	1,399,940	1,249,813
Customs duties	(251,189)	(258,262)
Excise tax	(20,480)	(44,931)
Net sales	1,128,271	946,620
Volumes in bcm	109.4	80.4
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	182.2	269.5
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	12,798.3	15,551.5
<i>Former Soviet Union countries</i>		
Gross sales ⁽¹⁾	182,139	254,698
Customs duties	(15,518)	(25,060)
Net sales	166,621	229,638
Volumes in bcm	16.4	20.9
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	158.6	211.0
Average price, RUB per mcm ⁽²⁾ (including customs duties)	11,135.9	12,176.6
<i>Russian Federation</i>		
Gross sales (net of VAT)	420,395	425,284
Net sales	420,395	425,284
Volumes in bcm	109.7	120.0
Average price, RUB per mcm ⁽²⁾ (net of VAT)	3,831.0	3,543.0
<i>Total sales of gas</i>		
Gross sales (net of VAT)	2,002,474	1,929,795
Customs duties	(266,707)	(283,322)
Excise tax	(20,480)	(44,931)
Retroactive gas price adjustments	39,984	17,220
Net sales	1,755,271	1,618,762
Volumes in bcm	235.5	221.3
Net sales of refined products (net of excise tax, VAT and customs duties)	703,468	761,603
Electric and heat energy net sales (net of VAT)	236,292	217,728
Net sales of crude oil and gas condensate (net of VAT and customs duties)	166,549	130,652
Gas transportation net sales (net of VAT)	95,772	90,621
Other revenues (net of VAT)	<u>107,020</u>	<u>94,086</u>
Total sales (net of excise tax, VAT and customs duties)	3,064,372	2,913,452

Notes:

⁽¹⁾ VAT is not charged on sales to Europe and Other countries as well as Former Soviet Union countries.

⁽²⁾ One mcm is equivalent to 35,316 cubic feet.

⁽³⁾ Calculated on the basis of average exchange rate between RUB and US Dollar.

Total sales (net of excise tax, VAT and customs duties) increased by RUB 150,920 million, or 5 %, to RUB 3,064,372 million for the six months ended June 30, 2016 compared to the same period of the prior year. The increase in sales was mainly driven by the increase in sales of gas to Europe and Other countries.

Net sales of gas accounted for 57 % of total net sales for the six months ended June 30, 2016 (56 % for the same period of the prior year).

Net sales of gas increased by RUB 136,509 million, or 8 %, from RUB 1,618,762 million for the six months ended June 30, 2015 to RUB 1,755,271 million for the six months ended June 30, 2016.

Net sales of gas to Europe and Other countries increased by RUB 181,651 million, or 19 %, to RUB 1,128,271 million for the six months ended June 30, 2016 compared to the same period of the prior year. The increase in sales of gas to Europe and Other countries was driven by the 36 % increase in volumes of gas sold for the six months ended June 30, 2016 compared to the same period of the prior year. At the same time average Russian Ruble prices (including excise tax and customs duties) decreased by 18 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries decreased by RUB 63,017 million, or 27 %, to RUB 166,621 million for the six months ended June 30, 2016 compared to the same period of the prior year. The change was due to the decrease in volumes of gas sold by 22 % and the decrease in average Russian Ruble prices (including customs duties) by 9 % for the six months ended June 30, 2016.

Net sales of gas in the Russian Federation decreased by RUB 4,889 million, or 1 %, to RUB 420,395 million for the six months ended June 30, 2016 compared to the same period of the prior year. This is explained by the decrease in volumes of gas sold by 9 % compared to the same period of the prior year. At the same time the average Russian Ruble price (net of VAT) increased by 8 %.

Operating expenses

Operating expenses increased by 21 % for the six months ended June 30, 2016 to RUB 2,680,732 million from RUB 2,224,215 million for the same period of the prior year. Operating expenses as a percentage of sales increased from 76 % for the six months ended June 30, 2015 to 87 % for the six months ended June 30, 2016. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Six months ended June 30,	
	2016	2015
Purchased gas and oil	627,258	391,851
Taxes other than on income	429,493	429,063
Staff costs	333,876	289,681
Transit of gas, oil and refined products	303,790	242,826
Depreciation	282,115	250,635
Materials	129,477	128,941
Cost of goods for resale, including refined products	76,089	92,273
Charge for impairment provisions	63,424	29,573
Foreign exchange rate differences on operating items	63,319	50,178
Repairs and maintenance	61,828	54,595
Electricity and heating expenses	44,954	45,295
Rental expenses	18,023	20,449
Transportation services	15,808	20,205
Insurance expenses	14,699	12,475
Social expenses	14,418	13,367
Research and development expenses	13,076	13,335
Derivatives losses (gains)	10,203	(16,046)
Processing services	7,821	9,073
Other	150,307	171,201
	<u>2,659,978</u>	<u>2,248,970</u>
Changes in inventories of finished goods, work in progress and other effects	20,754	(24,755)
Total operating expenses	2,680,732	2,224,215

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 235,407 million to RUB 627,258 million for the six months ended June 30, 2016 compared to RUB 391,851 million for the same period of the prior year.

Cost of purchased gas increased by RUB 215,353 million, or 76 %, to RUB 499,486 million for the six months ended June 30, 2016 compared to RUB 284,133 million for the same period of the prior year. This increase was related to the completion of the Swap Agreement between PJSC Gazprom and Wintershall Holding GmbH which resulted in acquisition of control over W & G Beteiligungs-GmbH & Co. KG and WIEH GmbH & Co. KG and their subsidiaries which operate as natural gas trading and storage companies.

Cost of purchased oil included in the purchased gas and oil increased by RUB 20,054 million, or 19 %, to RUB 127,772 million for the six months ended June 30, 2016 compared to RUB 107,718 million for the same period of the prior year. This change is mainly related to an increase in volumes of oil purchased on domestic market.

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Six months ended	
	June 30,	
	2016	2015
Mineral extraction tax	290,577	320,047
Property tax	64,285	60,022
Other taxes	74,631	48,994
Taxes other than on income	429,493	429,063

Mineral extraction tax decreased by 9 % to RUB 290,577 million for the six months ended June 30, 2016 compared to RUB 320,047 million for the same period of the prior year. This change was due to a decrease of oil prices.

Staff costs

Staff costs increased by 15 % to RUB 333,876 million for the six months ended June 30, 2016 compared to RUB 289,681 million for the same period of the prior year. The increase was mainly driven by average salary growth.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 25 % to RUB 303,790 million for the six months ended June 30, 2016 compared to RUB 242,826 million for the same period of the prior year. This increase was mainly driven by an increase in cost of transit of gas through the territory of Ukraine denominated in Ruble terms and the activity of the GAZPROM Germania Group.

Depreciation

Depreciation increased by RUB 31,480 million, or 13 %, to RUB 282,115 million for the six months ended June 30, 2016 compared to RUB 250,635 million for the same period of the prior year. The increase was primarily due to the growth in the fixed assets base.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products, decreased by RUB 16,184 million, or 18 %, to RUB 76,089 million for the six months ended June 30, 2016 compared to RUB 92,273 million for the same period of the prior year. The decrease was mainly explained by a decrease in volumes of refined products purchased and a decrease in oil and oil products prices.

Charge for impairment and other provisions, net

Charge for impairment and other provisions, net increased by RUB 33,851 million or 114 % for the six months ended June 30, 2016 compared to the same period of the prior year. This change was mainly driven by an increase of charge for impairment allowance for doubtful trade accounts receivable of NJSC Naftogaz Ukraine and charge for impairment allowance for doubtful prepayments.

Foreign exchange rate differences on operating items

Foreign exchange rate differences on operating items increased by RUB 13,141 million and amounted to a net loss of RUB 63,319 million for the six months ended June 30, 2016 compared to a net loss of RUB 50,178 million for the same period of the prior year. This change was explained by the depreciation of US Dollar against the Russian Rouble by 12 % and the depreciation of Euro against the Russian Rouble by 11 % for the six months ended June 30, 2016 compared to the depreciation of US Dollar against the Russian Rouble by 1 % and the depreciation of Euro against the Russian Rouble by 10 % for the same period of the prior year.

Other operating expenses

Other operating expenses decreased by 12 % to RUB 150,307 million for the six months ended June 30, 2016 compared to RUB 171,201 million for the same period of the prior year. Other expenses include gas and gas condensate production expense, services from gas distribution companies, bank charges, security services, legal and consulting services, charity and financial aid, and advertising.

Changes in inventories of finished goods, work in progress and other effects

Changes in inventories of finished goods, work in progress and other effects increased by RUB 45,509 million to a positive value of RUB 20,754 million for the six months ended June 30, 2016 compared to a negative value of RUB 24,755 million for the same period of the prior year. The change in this line item is explained by the fact that for six months ended June 30, 2016 was an decrease in the balances of finished goods compared to a increase in the balances of finished goods for the same period of the prior year.

Operating profit

As a result of the factors discussed above, operating profit decreased by RUB 268,115 million, or 39 %, to RUB 413,169 million for the six months ended June 30, 2016 from RUB 681,284 million for the same period of the prior year. The operating profit margin decreased from 23 % for the six months ended June 30, 2015 to 13 % for the six months ended June 30, 2016.

Net finance income

(RUB million)	Six months ended June 30,	
	2016	2015
Exchange gains	645,632	1,007,461
Exchange losses	<u>(331,278)</u>	<u>(922,390)</u>
Net exchange gain	314,354	85,071
Interest income	54,636	55,842
Interest expense	<u>(36,109)</u>	<u>(27,032)</u>
Net finance income	332,881	113,881

The increase in net exchange gain in the amount by RUB 229,283 million, or 270 %, from RUB 85,071 for the six months ended June 30, 2015 to RUB 314,354 for the six months ended June 30, 2016 mainly explained by the depreciation of US Dollar and Euro against the Russian Rouble by 12 % and 11 %, respectively, for the six months ended June 30, 2016 compared to the depreciation of US Dollar and Euro against the Russian Rouble by 1 % and 10 %, respectively, for the same period of the prior year.

Interest income decreased by 2 % to RUB 54,636 million for the six months ended June 30, 2016 from RUB 55,842 million for the same period of the prior year.

Interest expense increased by 34 % to RUB 36,109 million for the six months ended June 30, 2016 compared to RUB 27,032 million for the same period of the prior year.

Share of net income of associates and joint ventures

Share of net income of associates and joint ventures decreased by RUB 27,649 million to RUB 33,766 million for the six months ended June 30, 2016 compared to RUB 61,415 million for the same period of the prior year. This change was mainly caused by the decrease in the share of net income of Sakhalin Energy Investment Company Ltd. by RUB 33,174 million that was partially compensated by the increase in the share of net income of Gazprombank (Joint Stock Company) and its subsidiaries by RUB 15,519 million.

Profit tax

Total profit tax expense decreased by RUB 10,322 million, or 6 %, to RUB 155,432 million for the six months ended June 30, 2016 compared to RUB 165,754 million for the same period of the prior year. The effective profit tax rate was 19.9 % and 19.3 % for the six months ended June 30, 2016 and 2015, respectively.

The change in effective profit tax rate was mainly driven by a decrease in non-deductible income for tax purposes related to the share of net income of associates and joint ventures and an increase in share of non-deductible expenses for tax purposes for the six months ended June 30, 2016 compared for the same period of the prior year.

Profit for the period attributable to owners of PJSC Gazprom

As a result of the factors discussed above, profit for the period attributable to owners of PJSC Gazprom decreased by

RUB 68,744 million, or 10 %, from RUB 675,904 million for the six months ended June 30, 2015 to RUB 607,160 million for the six months ended June 30, 2016.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 2,893 million, or 19 %, to RUB 18,245 million for the six months ended June 30, 2016 compared to RUB 15,352 million for the same period of the prior year.

Liquidity and capital resources

The following table summarises the cash flows for the six months ended June 30, 2016 and 2015:

(RUB million)	Six months ended June 30,	
	2016	2015
Net cash from operating activities	931,592	985,237
Net cash used in investing activities	(822,608)	(839,373)
Net cash used in financing activities	(44,131)	(53,458)

Net cash from operating activities

Net cash from operating activities decreased by RUB 53,645 million, or 5 %, to RUB 931,592 million for the six months ended June 30, 2016 compared to RUB 985,237 million for the same period of the prior year. This change was mainly driven by a decrease in cash from operating activities before working capital changes.

Net cash used in investing activities

Net cash used in investing activities decreased by RUB 16,765 million, or 2 %, to RUB 822,608 million for the six months ended June 30, 2016 compared to RUB 839,373 million for the same period of the prior year. The change was primarily due to a decrease in cash used for capital expenditures, proceeds from the sale of associates and an increase in interest received for the six months ended June 30, 2016.

Net cash used in financing activities

Net cash used in financing activities decreased by RUB 9,327 million to RUB 44,131 million for the six months ended June 30, 2016 compared to RUB 53,458 million for the same period of the prior year. This change was primarily due to decrease of cash outflow from borrowings for the six months ended June 30, 2016 compared to this figure for the same period of the prior year.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the six months ended June 30, 2016 and 2015 in RUB terms, amounted to the following:

(RUB million)	Six months ended June 30,	
	2016 ⁽¹⁾	2015 ⁽¹⁾
Transportation	216,483	245,686
Production of crude oil and gas condensate	163,214	142,164
Production of gas	95,414	65,961
Refining	58,988	57,092
Electric and heat energy generation and sales	31,731	30,549
Gas storage	17,723	8,414
Distribution of gas	7,549	4,976
All other segments	<u>26,227</u>	<u>25,456</u>
Total	617,329	580,298

Note:

⁽¹⁾The capital expenditures in the present analysis differ from the capital additions disclosed within the Group's operating segments in IFRS consolidated interim condensed financial information for the six months ended June 30, 2016 of PJSC Gazprom primarily due to VAT.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RUB 37,031 million, or 6 %, from RUB 580,298 million for the six months ended June 30, 2015 to RUB 617,329 million for the six months ended June 30, 2016.

Debts

Net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) decreased by RUB 319,993 million, or 15 %, from RUB 2,083,120 million as of December 31, 2015 to RUB 1,763,127 million as of June 30, 2016. This decrease was resulted from a change in foreign currency exchange rates (depreciation of US Dollar and Euro).