

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 nine months ended September 30, 2018. 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 nine months ended September 30, 2018 should be read in conjunction with the consolidated financial statements for the year ended December 31, 2017 prepared in accordance with International Financial Reporting Standards.

OVERVIEW

We are one of the world's largest gas and oil companies in terms of volume of reserves, production of gas and market capitalisation. Our revenue is primarily derived from sales of natural gas, crude oil and other hydrocarbon products to countries of 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 comprise production of other products and sales individual types of goods, works, and services.

The official Russian Ruble to US Dollar foreign exchange rate as determined by the Central Bank of the Russian Federation was as follows:

- as of September 30, 2018 – 65.5906 (as of September 30, 2017 – 58.0169);
- as of December 31, 2017 – 57.6002 (as of December 31, 2016 – 60.6569).

The official Russian Ruble to Euro foreign exchange rate as determined by the Central Bank of the Russian Federation was as follows:

- as of September 30, 2018 – 76.2294 (as of September 30, 2017 – 68.4483);
- as of December 31, 2017 – 68.8668 (as of December 31, 2016 – 63.8111).

The average exchange rates of Russian Ruble for the nine months ended September 30, 2018 and for the nine months ended September 30, 2017 were:

- to US Dollar – 61.4358 and 58.3344, respectively;
- to Euro – 73.2921 and 64.9319, respectively.

RESULTS OF OPERATION

(in RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Sales	1,930,036	1,431,662	5,901,591	4,641,596
Net gain (loss) from trading activity	9,342	5,918	7,048	(14,409)
Operating expenses	(1,414,385)	(1,214,231)	(4,450,034)	(3,876,133)
Impairment loss on financial assets	<u>(19,315)</u>	<u>(11,666)</u>	<u>(73,654)</u>	<u>(55,020)</u>
Operating profit	505,678	211,683	1,384,951	696,034
Finance income	156,954	102,305	416,893	338,349
Finance expense	(240,290)	(78,710)	(635,122)	(318,337)
Share of profit of associates and joint ventures	<u>57,597</u>	<u>27,861</u>	<u>149,180</u>	<u>83,830</u>
Profit before profit tax	479,939	263,139	1,315,902	799,876
Current profit tax expense	(78,169)	(47,657)	(181,390)	(130,819)
Deferred profit tax expense	<u>(1,235)</u>	<u>(7,911)</u>	<u>(70,426)</u>	<u>(53,432)</u>
Profit tax	(79,404)	(55,568)	(251,816)	(184,251)
Profit for the period	400,535	207,571	1,064,086	615,625
Other comprehensive income (loss):				
Items that will not be reclassified to profit or loss:				
Gain (loss) arising from changes in fair value of financial assets measured at fair value through other comprehensive income, net of tax	83,309	7,138	154,315	(33,089)
Remeasurement of provision for post-employment benefits	<u>68,973</u>	<u>(44,515)</u>	<u>84,316</u>	<u>(58,751)</u>
Total other comprehensive income (loss) that will not be reclassified to profit or loss	152,282	(37,377)	238,631	(91,840)
Items that may be reclassified subsequently to profit or loss:				
Share of other comprehensive income of associates and joint ventures	1,657	356	3,315	2,481
Translation differences	57,733	(1,372)	148,670	21,741
Gain (loss) from hedging operations, net of tax	<u>8,341</u>	<u>799</u>	<u>35,292</u>	<u>(3,624)</u>
Total other comprehensive income (loss) that may be reclassified subsequently to profit or loss	67,731	(217)	187,277	20,598
Total other comprehensive income (loss) for the period, net of tax	<u>220,013</u>	<u>(37,594)</u>	<u>425,908</u>	<u>(71,242)</u>
Comprehensive income for the period	620,548	169,977	1,489,994	544,383
Profit for the period attributable to:				
Owners of PJSC Gazprom	386,446	200,488	1,017,250	581,834
Non-controlling interest	<u>14,089</u>	<u>7,083</u>	<u>46,836</u>	<u>33,791</u>
	400,535	207,571	1,064,086	615,625
Comprehensive income for the period attributable to:				
Owners of PJSC Gazprom	603,019	161,156	1,434,403	504,183
Non-controlling interest	<u>17,529</u>	<u>8,821</u>	<u>55,591</u>	<u>40,200</u>
	620,548	169,977	1,489,994	544,383

Sales

The following table sets out volumes and sales prices:

(in RUB million unless indicated otherwise)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Sales of gas				
<i>Europe and other countries</i>				
Gross sales ⁽¹⁾	934,774	628,406	2,715,098	1,952,011
Customs duties	(193,773)	(120,612)	(536,682)	(367,637)
Excise tax	(11,781)	(14,268)	(37,891)	(37,059)
Net sales	729,220	493,526	2,140,525	1,547,315
Volumes in bcm	56.9	54.7	185.4	173.8
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	250.8	194.6	237.7	192.8
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	16,427.1	11,485.3	14,647.3	11,233.1
<i>Former Soviet Union countries</i>				
Gross sales ⁽¹⁾	77,447	55,925	261,226	223,119
Customs duties	(8,863)	(5,027)	(25,618)	(20,953)
Net sales	68,584	50,898	235,608	202,166
Volumes in bcm	6.5	5.7	27.1	24.1
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	180.7	165.1	156.4	158.9
Average price, RUB per mcm ⁽²⁾ (including customs duties)	11,836.7	9,744.7	9,635.4	9,259.2
<i>Russian Federation</i>				
Gross sales (net of VAT)	128,108	121,453	636,873	587,978
Net sales	128,108	121,453	636,873	587,978
Volumes in bcm	33.4	32.9	163.0	157.0
Average price, RUB per mcm ⁽²⁾ (net of VAT)	3,831.4	3,691.7	3,906.5	3,746.2
<i>Total sales of gas</i>				
Gross sales (net of VAT)	1,140,329	805,784	3,613,197	2,763,108
Customs duties	(202,636)	(125,639)	(562,300)	(388,590)
Excise tax	(11,781)	(14,268)	(37,891)	(37,059)
Retroactive gas price adjustments	(109)	2,076	37,686	(5,228)
Net sales	925,803	667,953	3,050,692	2,332,231
Volumes in bcm	96.8	93.3	375.5	354.9
Net sales of refined products (net of excise tax, VAT and customs duties)	594,652	445,998	1,586,225	1,226,810
Net sales of crude oil and gas condensate (net of VAT and customs duties)	205,055	114,655	550,711	387,953
Electric and heat energy net sales (net of VAT)	87,596	86,444	361,769	349,599
Gas transportation net sales (net of VAT)	54,538	57,046	168,292	174,528
Other sales (net of VAT)	<u>62,392</u>	<u>59,566</u>	<u>183,902</u>	<u>170,475</u>
Total sales (net of excise tax, VAT and customs duties)	1,930,036	1,431,662	5,901,591	4,641,596

Notes:

⁽¹⁾ VAT is not charged on sales of gas 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 the Russian Ruble and US Dollar.

Total sales (net of excise tax, VAT and customs duties) increased by RUB 1,259,995 million, or 27 %, to RUB 5,901,591 million for the nine months ended September 30, 2018 compared to the same period of the prior year. The increase in sales was mainly due to an increase in sales of gas, refined products, crude oil and gas condensate.

Net sales of gas accounted for 52 % of total net sales for the nine months ended September 30, 2018 (50 % for the same period of the prior year).

Net sales of gas increased by RUB 718,461 million, or 31 %, from RUB 2,332,231 million for the nine months ended September 30, 2017 to RUB 3,050,692 million for the nine months ended September 30, 2018.

Net sales of gas to Europe and other countries increased by RUB 593,210 million, or 38 %, to RUB 2,140,525 million for the nine months ended September 30, 2018 compared to the same period of the prior year. The change was driven by the increase in average prices denominated in Russian Ruble (including excise tax and customs duties) by 30 % and the increase in volumes of the gas sold by 7 % for the nine months ended September 30, 2018 compared to the same period of the prior year. At the same time the average prices denominated in US Dollar increased by 23 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries increased by RUB 33,442 million, or 17 %, to RUB 235,608 million for the nine months ended September 30, 2018 compared to the same period of the prior year. The change was due to the increase in volumes of gas sold by 12 % and the increase in average prices denominated in Russian Ruble (including customs duties) by 4 % for the nine months ended September 30, 2018.

Net sales of gas in the Russian Federation increased by RUB 48,895 million, or 8 %, to RUB 636,873 million for the nine months ended September 30, 2018 compared to the same period of the prior year. This change is explained by the increase in volumes of gas sold by 4 % and the increase in average prices denominated in Russian Ruble (net of VAT) by 4 %.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 359,415 million, or 29 %, to RUB 1,586,225 million for the nine months ended September 30, 2018 compared to the same period of the prior year. The increase in sales of refined products was mainly due to an increase in average prices in all geographic segments and an increase in Gazprom Neft Group sales volumes.

Net sales of crude oil and gas condensate (net of VAT and customs duties) increased by RUB 162,758 million, or 42 %, to RUB 550,711 million for the nine months ended September 30, 2018 compared to the same period of the prior year. The increase in sales of crude oil was mainly due to an increase in average prices.

Operating expenses

Operating expenses increased by RUB 573,901 million, or 15 %, for the nine months ended September 30, 2018 to RUB 4,450,034 million compared to RUB 3,876,133 million for the same period of the prior year. Operating expenses as a percentage of sales decreased from 84 % for the nine months ended September 30, 2017 to 75 % for the nine months ended September 30, 2018. The table below presents a breakdown of operating expenses in each period:

(in RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Purchased gas and oil	368,419	272,407	1,112,961	838,007
Taxes other than on profit	386,480	303,565	1,054,965	869,742
Staff costs	183,560	173,907	562,331	514,981
Depreciation	157,589	145,276	476,136	448,579
Transit of gas, oil and refined products	169,509	152,486	472,992	440,317
Cost of goods for resale, including refined products	63,585	57,612	187,334	170,451
Materials	57,076	67,091	185,621	191,604
Repairs and maintenance	41,249	46,383	93,925	105,566
Electricity and heating expenses	23,797	24,547	81,405	77,631
Rental expenses	10,535	7,917	30,001	28,797
Social expenses	8,717	8,678	25,157	23,898
Insurance expenses	8,312	7,062	23,904	21,594
Transportation services	6,010	4,335	22,971	20,071
Processing services	4,958	4,338	14,079	11,789
Research and development expenses	1,294	4,029	8,823	10,236
(Profit on recovery) impairment loss on non-financial assets	(153)	(1,311)	5,005	9,539
Derivatives gain	(22,227)	(4,348)	(6,072)	(11,699)
Foreign exchange rate differences on operating items	(11,782)	(594)	(20,573)	(9,354)
Other	67,940	95,252	244,663	273,084
	1,524,868	1,368,632	4,575,628	4,034,833
Change in inventories of finished goods, work in progress and other effects	(110,483)	(154,401)	(125,594)	(158,700)
Total operating expenses	1,414,385	1,214,231	4,450,034	3,876,133

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 274,954 million, or 33 %, to RUB 1,112,961 million for the nine months ended September 30, 2018 compared to RUB 838,007 million for the same period of the prior year.

Cost of purchased gas increased by RUB 148,580 million, or 25 %, to RUB 747,781 million for the nine months ended September 30, 2018 compared to RUB 599,201 million for the same period of the prior year. The change was due to an increase in average prices and an increase in volumes of gas purchased from external suppliers.

Cost of purchased oil included in the purchased gas and oil increased by RUB 126,374 million, or 53 %, to RUB 365,180 million for the nine months ended September 30, 2018 compared to RUB 238,806 million for the same period of the prior year. This change was mainly due to an increase in prices of oil.

Taxes other than on profit

Taxes other than on profit consist of:

(in RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Mineral extraction tax	305,299	215,495	798,047	622,044
Excise tax	35,982	45,536	121,108	120,127
Property tax	40,911	37,938	124,573	118,555
Other taxes	4,288	4,596	11,237	9,016
Taxes other than on profit	386,480	303,565	1,054,965	869,742

Mineral extraction tax (MET) increased by RUB 176,003 million, or 28 %, to RUB 798,047 million for the nine months ended September 30, 2018 compared to RUB 622,044 million for the same period of the prior year, mainly as a result of an increase in crude oil prices and an increase in the adjusting coefficient of the crude oil MET formula for the nine months ended September, 30 2018 compared to the same period of the prior year, and also due to an increase in the MET rate for gas since September 1, 2018.

Foreign exchange rate differences on operating items

Foreign exchange gain increased by RUB 11,219 million, or 120 %, to RUB 20,573 million for the nine months ended September 30, 2018 compared to a foreign exchange gain of RUB 9,354 million for the same period of the prior year. This change was explained by the appreciation of US Dollar and Euro against the Russian Ruble by 14 % and 11 %, respectively, for the nine months ended September 30, 2018 compared to the depreciation of US Dollar against the Russian Ruble by 4 % and the appreciation of Euro against the Russian Ruble by 7 % for the same period of the prior year.

Impairment loss on financial assets

Impairment loss on financial assets increased by RUB 18,634 million, or 34 %, to RUB 73,654 million for the nine months ended September 30, 2018 compared to loss in the amount of RUB 55,020 million for the same period of the prior year. The change is mainly due to an increase in the amount of the allowance for expected credit losses on receivables due from NJSC Naftogaz of Ukraine and JSV Moldovagaz.

Operating profit

As a result of the factors discussed above, operating profit increased by RUB 688,917 million, or 99 %, to RUB 1,384,951 million for the nine months ended September 30, 2018 compared to RUB 696,034 million for the same period of the prior year. The operating profit margin increased from 15 % for the nine months ended September 30, 2017 to 23 % for the nine months ended September 30, 2018.

Net finance (expense) income

(in RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2018	2017	2018	2017
Foreign exchange gain	140,237	81,564	363,328	272,945
Foreign exchange loss	<u>(228,549)</u>	<u>(70,931)</u>	<u>(597,702)</u>	<u>(279,615)</u>
Net foreign exchange (loss) gain	(88,312)	10,633	(234,374)	(6,670)
Interest income	16,717	20,741	53,565	65,404
Interest expense	<u>(11,741)</u>	<u>(7,779)</u>	<u>(37,420)</u>	<u>(38,722)</u>
Net finance (expense) income	(83,336)	23,595	(218,229)	20,012

The net foreign exchange loss increased by RUB 227,704 million to RUB 234,374 million for the nine months ended September 30, 2018 compared to the net foreign exchange loss of RUB 6,670 million for the same period of the prior year. The change is due to the appreciation of US Dollar and Euro against the Russian Ruble by 14 % and 11 %, respectively, for the nine months ended September 30, 2018 compared to the depreciation of US Dollar against the Russian Ruble by 4 % and appreciation of Euro against the Russian Ruble by 7 % for the same period of the prior year.

Interest income decreased by RUB 11,839 million, or 18 %, to RUB 53,565 million for the nine months ended September 30, 2018 compared to RUB 65,404 million for the same period of the prior year.

Interest expense decreased by RUB 1,302 million, or 3 %, to RUB 37,420 million for the nine months ended September 30, 2018 compared to RUB 38,722 million for the same period of the prior year.

Share of profit of associates and joint ventures

Share of profit of associates and joint ventures increased by RUB 65,350 million, or 78 %, to RUB 149,180 million for the nine months ended September 30, 2018 compared to RUB 83,830 million for the same period of the prior year. This change was mainly caused by an increase in the share of profit of Sakhalin Energy Investment Company Ltd., JSC Arcticgas and JSC Messoyakhaneftegaz.

Profit tax

Total profit tax increased by RUB 67,565 million, or 37 %, to RUB 251,816 million for the nine months ended September 30, 2018 compared to RUB 184,251 million for the same period of the prior year. The effective profit tax rate was 19.1 % and 23.0 % for the nine months ended September 30, 2018 and September 30, 2017, respectively.

Profit for the period attributable to owners of PJSC Gazprom

As a result of the factors discussed above, profit attributable to owners of PJSC Gazprom increased by RUB 435,416 million, or 75 %, to RUB 1,017,250 million for the nine months ended September 30, 2018 compared to RUB 581,834 million for the same period of the prior year.

Profit for the period attributable to non-controlling interest

Profit attributable to non-controlling interest increased by RUB 13,045 million, or 39 %, to RUB 46,836 million for the nine months ended September 30, 2018 compared to RUB 33,791 million for the same period of the prior year.

Liquidity and capital resources

The following table summarises the cash flows for the nine months ended September 30, 2018 and September 30, 2017:

(in RUB million)	Nine months ended September 30,	
	2018	2017
Net cash from operating activities	1,426,348	612,817
Net cash used in investing activities	(1,184,448)	(1,083,937)
Net cash (used in) from financing activities	(284,824)	62,572

Net cash from operating activities

Net cash from operating activities increased by RUB 813,531 million, or 133 %, to RUB 1,426,348 million for the nine months ended September 30, 2018 compared to RUB 612,817 million for the same period of the prior year. This change was mainly driven by an increase in cash from operating activities before working capital changes compared to the same period of the prior year.

Net cash used in investing activities

Net cash used in investing activities increased by RUB 100,511 million, or 9 %, to RUB 1,184,448 million for the nine months ended September 30, 2018 compared to RUB 1,083,937 million for the same period of the prior year. The change was mainly due to an increase of capital expenditures for the nine months ended September 30, 2018 compared to the same period of the prior year.

Net cash (used in) from financing activities

Net cash used in financing activities amounted to RUB 284,824 million for the nine months ended September 30, 2018 compared to RUB 62,572 million of net cash from financing activities for the same period of the prior year. This change was mainly due to the excess of repayment of borrowings over proceeds from borrowings for the nine months ended September 30, 2018, compared to the excess of proceeds from borrowings over repayment of borrowings for the same period of the prior year.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segments for the nine months ended September 30, 2018 and September 30, 2017 denominated in the Russian Ruble are presented in the following table:

(in RUB million)	Nine months ended September 30,	
	2018	2017
Transportation	405,293	305,012
Refining	208,141	135,645
Production of crude oil and gas condensate	172,259	194,635
Production of gas	168,426	107,695
Electric and heat energy generation and sales	35,950	26,192
Distribution of gas	27,582	19,094
Gas storage	6,396	12,335
All other segments	84,449	73,374
Total	1,108,496	873,982

Total capital expenditures increased by RUB 234,514 million, or 27 %, from RUB 873,982 million for the nine months ended September 30, 2017 to RUB 1,108,496 million for the nine months ended September 30, 2018.

Debts obligation

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) increased by RUB 229,095 million, or 10 %, from RUB 2,397,511 million as of December 31, 2017 to RUB 2,626,606 million as of September 30, 2018. This change was mainly due to an increase in the amount of long-term borrowings denominated in the Russian Ruble caused by the appreciation of US Dollar and Euro against the Russian Ruble.