

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, 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 nine months ended September 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)

	Nine months ended September 30,	
	2016	2015
Sales	4,321,364	4,206,217
Net gain from trading activity	71,159	8,320
Operating expenses	<u>(3,824,703)</u>	<u>(3,171,784)</u>
Operating profit	567,820	1,042,753
Finance income	816,264	1,145,005
Finance expense	(499,487)	(1,421,168)
Share of net income of associates and joint ventures	55,258	93,181
Gain on disposal of available-for-sale financial assets	<u>1,835</u>	<u>5,066</u>
Profit before profit tax	941,690	864,837
Current profit tax expense	(134,515)	(130,177)
Deferred profit tax expense	<u>(69,784)</u>	<u>(44,389)</u>
Profit tax	(204,299)	(174,566)
Profit for the period	737,391	690,271
Other comprehensive income (loss):		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(92,446)</u>	<u>(84,204)</u>
Total items that will not be reclassified to profit or loss	(92,446)	(84,204)
Items that will be reclassified subsequently to profit or loss:		
Gain arising from change in fair value of available-for-sale financial assets, net of tax	34,293	47,294
Share of other comprehensive (loss) income of associates and joint ventures	(7,756)	26,133
Translation differences	(201,260)	164,804
Gain (loss) from cash flow hedges, net of tax	<u>41,277</u>	<u>(4,777)</u>
Total items that may be reclassified subsequently to profit or loss	(133,446)	233,454
Other comprehensive (loss) income for the period, net of tax	(225,892)	149,250
Total comprehensive income for the period	511,499	839,521
Profit for the period attributable to:		
Owners of PJSC Gazprom	709,321	673,904
Non-controlling interest	<u>28,070</u>	<u>16,367</u>
	737,391	690,271
Total comprehensive income for the period attributable to:		
Owners of PJSC Gazprom	491,850	815,437
Non-controlling interest	<u>19,649</u>	<u>24,084</u>
	511,499	839,521

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Nine months ended September 30,	
	2016	2015
Sales of gas		
<i>Europe and Other countries</i>		
Gross sales ⁽¹⁾	1,930,031	1,883,132
Customs duties	(355,160)	(390,265)
Excise tax	(28,338)	(62,395)
Net sales	1,546,533	1,430,472
Volumes in bcm	160.9	125.3
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	175.9	252.1
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	11,993.7	15,033.7
<i>Former Soviet Union countries</i>		
Gross sales ⁽¹⁾	234,101	323,496
Customs duties	(19,655)	(31,494)
Net sales	214,446	292,002
Volumes in bcm	22.0	27.2
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	155.7	199.2
Average price, RUB per mcm ⁽²⁾ (including customs duties)	10,618.3	11,875.3
<i>Russian Federation</i>		
Gross sales (net of VAT)	530,683	538,572
Net sales	530,683	538,572
Volumes in bcm	139.7	150.6
Average price, RUB per mcm ⁽²⁾ (net of VAT)	3,797.9	3,576.7
<i>Total sales of gas</i>		
Gross sales (net of VAT)	2,694,815	2,745,200
Customs duties	(374,815)	(421,759)
Excise tax	(28,338)	(62,395)
Retroactive gas price adjustments	33,757	12,074
Net sales	2,325,419	2,273,120
Volumes in bcm	322.6	303.1
Net sales of refined products (net of excise tax, VAT and customs duties)	1,096,331	1,175,078
Electric and heat energy net sales (net of VAT)	322,708	291,603
Net sales of crude oil and gas condensate (net of VAT and customs duties)	271,545	184,636
Gas transportation net sales (net of VAT)	145,766	139,068
Other revenues (net of VAT)	<u>159,595</u>	<u>142,712</u>
Total sales (net of excise tax, VAT and customs duties)	4,321,364	4,206,217

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 115,147 million, or 3 %, to RUB 4,321,364 million for the nine months ended September 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 54 % of total net sales for the nine months ended September 30, 2016 (54 % for the same period of the prior year).

Net sales of gas increased by RUB 52,299 million, or 2 %, from RUB 2,273,120 million for the nine months ended September 30, 2015 to RUB 2,325,419 million for the nine months ended September 30, 2016.

Net sales of gas to Europe and Other countries increased by RUB 116,061 million, or 8 %, to RUB 1,546,533 million for the nine months ended September 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 28 % increase in volumes of gas sold for the nine months ended September 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 20 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries decreased by RUB 77,556 million, or 27 %, to RUB 214,446 million for the nine months ended September 30, 2016 compared to the same period of the prior year. The change was due to the decrease in volumes of gas sold by 19 % and the decrease in average Russian Ruble prices (including customs duties) by 11 % for the nine months ended September 30, 2016.

Net sales of gas in the Russian Federation decreased by RUB 7,889 million, or 1 %, to RUB 530,683 million for the nine months ended September 30, 2016 compared to the same period of the prior year. This is explained by the decrease in volumes of gas sold by 7 % compared to the same period of the prior year. At the same time the average Russian Ruble prices (net of VAT) increased by 6 %.

Operating expenses

Operating expenses increased by 21 % for the nine months ended September 30, 2016 to RUB 3,824,703 million from RUB 3,171,784 million for the same period of the prior year. Operating expenses as a percentage of sales increased from 75 % for the nine months ended September 30, 2015 to 89 % for the nine months ended September 30, 2016. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Nine months ended September 30,	
	2016	2015
Purchased gas and oil	896,182	605,902
Taxes other than on income	644,551	611,932
Staff costs	493,313	433,120
Transit of gas, oil and refined products	454,096	381,481
Depreciation	423,650	380,041
Materials	205,129	201,581
Cost of goods for resale, including refined products	133,998	145,772
Repairs and maintenance	108,626	106,109
Charge for impairment and other provisions	79,553	51,964
Electricity and heating expenses	69,854	64,752
Rental expenses	26,165	26,934
Research and development expenses	24,704	22,553
Transportation services	22,899	30,891
Insurance expenses	22,566	20,093
Social expenses	22,486	21,713
Foreign exchange rate differences on operating items	13,882	(47,668)
Processing services	11,643	14,004
Derivatives loss (gain)	10,851	(21,625)
Other	<u>225,402</u>	<u>229,111</u>
	3,889,550	3,278,660
Changes in inventories of finished goods, work in progress and other effects	<u>(64,847)</u>	<u>(106,876)</u>
Total operating expenses	3,824,703	3,171,784

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 290,280 million to RUB 896,182 million for the nine months ended September 30, 2016 compared to RUB 605,902 million for the same period of the prior year.

Cost of purchased gas increased by RUB 260,604 million, or 60 %, to RUB 698,400 million for the nine months ended September 30, 2016 compared to RUB 437,796 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 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 29,676 million, or 18 %, to RUB 197,782 million for the nine months ended September 30, 2016 compared to RUB 168,106 million for the same

period of the prior year. This change was 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)	Nine months ended September 30,	
	2016	2015
Mineral extraction tax	431,034	447,174
Property tax	95,526	88,355
Other taxes	<u>117,991</u>	<u>76,403</u>
Taxes other than on income	644,551	611,932

Mineral extraction tax decreased by 4 % to RUB 431,034 million for the nine months ended September 30, 2016 compared to RUB 447,174 million for the same period of the prior year. This change was due to a decrease of oil prices.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 19 % to RUB 454,096 million for the nine months ended September 30, 2016 compared to RUB 381,481 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 and Germany denominated in Ruble terms and the activity of the GAZPROM Germania Group.

Depreciation

Depreciation increased by RUB 43,609 million, or 11 %, to RUB 423,650 million for the nine months ended September 30, 2016 compared to RUB 380,041 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 11,774 million, or 8 %, to RUB 133,998 million for the nine months ended September 30, 2016 compared to RUB 145,772 million for the same period of the prior year. The decrease was mainly explained by a decrease in volumes of other products purchased.

Charge for impairment and other provisions

Charge for impairment and other provisions increased by RUB 27,589 million, or 53 %, for the nine months ended September 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 advances given.

Foreign exchange rate differences on operating items

Foreign exchange rate differences on operating items increased by RUB 61,550 million and amounted to a net loss of RUB 13,882 million for the nine months ended September 30, 2016 compared to a net gain of RUB 47,668 million for the same period of the prior year. This change was explained by the depreciation of US Dollar and Euro against the Russian Ruble by 13 % and 11 %, respectively, for the nine months ended September 30, 2016 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 18 % and 9 %, respectively, for the same period of the prior year.

Other operating expenses

Other operating expenses decreased by 2 % to RUB 225,402 million for the nine months ended September 30, 2016 compared to RUB 229,111 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 42,029 million to RUB 64,847 million for the nine months ended September 30, 2016 compared to RUB 106,876 million for the same period of the prior year. The change in this line item is explained by the fact that an increase in the balances of finished goods for the nine months ended September 30, 2016 was less than an 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 474,933 million, or 46 %, to RUB 567,820 million for the nine months ended September 30, 2016 from RUB 1,042,753 million for the same period of the prior year. The operating profit margin decreased from 25 % for the nine months ended September 30, 2015 to 13 % for the nine months ended September 30, 2016.

Net finance income (expense)

(RUB million)	Nine months ended September 30,	
	2016	2015
Foreign exchange gain	741,229	1,063,545
Foreign exchange loss	<u>(447,087)</u>	<u>(1,378,852)</u>
Net exchange gain (loss)	294,142	(315,307)
Interest income	75,035	81,460
Interest expense	<u>(52,400)</u>	<u>(42,316)</u>
Net finance income (expense)	316,777	(276,163)

The net exchange gain of RUB 294,142 million for the nine months ended September 30, 2016 compared to net exchange loss of RUB 315,307 million for the same period of the prior year was mainly explained by the depreciation of US Dollar and Euro against the Russian Ruble by 13 % and 11 %, respectively, for the nine months ended September 30, 2016 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 18 % and 9 %, respectively, for the same period of the prior year.

Interest income decreased by 8 % to RUB 75,035 million for the nine months ended September 30, 2016 from RUB 81,460 million for the same period of the prior year.

Interest expense increased by 24 % to RUB 52,400 million for the nine months ended September 30, 2016 compared to RUB 42,316 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 37,923 million to RUB 55,258 million for the nine months ended September 30, 2016 compared to RUB 93,181 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 47,079 million that was partially compensated by the increase in the share of net income of Gazprombank (Joint-Stock Company) and its subsidiaries by RUB 20,371 million.

Profit tax

Total profit tax decreased by RUB 29,733 million, or 17 %, to RUB 204,299 million for the nine months ended September 30, 2016 compared to RUB 174,566 million for the same period of the prior year. The effective profit tax rate was 21.7 % and 20.2 % for the nine months ended September 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 nine months ended September 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 increased by RUB 35,417 million, or 5 %, from RUB 673,904 million for the nine months ended September 30, 2015 to RUB 709,321 million for the nine months ended September 30, 2016.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 11,703 million, or 72 %, to RUB 28,070 million for the nine months ended September 30, 2016 compared to RUB 16,367 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, 2016 and 2015:

(RUB million)	Nine months ended September 30,	
	2016	2015
Net cash from operating activities	1,176,475	1,395,331
Net cash used in investing activities	(1,187,685)	(1,206,358)
Net cash used in financing activities	(459,559)	(153,389)

Net cash from operating activities

Net cash from operating activities decreased by RUB 218,856 million, or 16 %, to RUB 1,176,475 million for the nine months ended September 30, 2016 compared to RUB 1,395,331 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 18,673 million, or 2 %, to RUB 1,187,685 million for the nine months ended September 30, 2016 compared to RUB 1,206,358 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 nine months ended September 30, 2016.

Net cash used in financing activities

Net cash used in financing activities increased by RUB 306,170 million to RUB 459,559 million for the nine months ended September 30, 2016 compared to RUB 153,389 million for the same period of the prior year. This change was primarily due to excess of cash used for repayment of borrowings over proceeds from borrowings and the acquisition of treasure shares for the nine months ended September 30, 2016.

Capital expenditures

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

(RUB million)	Nine months ended September 30,	
	2016 ⁽¹⁾	2015 ⁽¹⁾
Transportation	275,044	377,316
Production of crude oil and gas condensate	256,736	219,640
Production of gas	186,370	154,756
Refining	106,245	125,115
Electric and heat energy generation and sales	49,830	54,477
Gas storage	27,629	20,135
Distribution of gas	25,603	11,927
All other segments	45,345	45,625
Total	972,802	1,008,991

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 nine months ended September 30, 2016 of PJSC Gazprom primarily due to VAT.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) decreased by RUB 36,189 million, or 3 %, from RUB 1,008,991 million for the nine months ended September 30, 2015 to RUB 972,802 million for the nine months ended September 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) increased by RUB 97,371 million, or 5 %, from RUB 2,083,120 million as of December 31, 2015 to RUB 2,180,491 million as of September 30, 2016. This increase was mainly resulted from a decrease in cash and cash equivalents that was partially compensated by a decrease in borrowings denominated in Ruble terms due to the depreciation of US Dollar and Euro.