

## 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, 2017. 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, 2017 should be read in conjunction with the consolidated financial statements for the year ended December 31, 2016 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 comprise production of other products and sales of various goods, works, and services.

The official Russian Ruble ("RUB") to US Dollar ("USD") foreign exchange rates as determined by the Central Bank of the Russian Federation were as follows:

- as of September 30, 2017 – 58.0169 (as of September 30, 2016 – 63.1581);
- as of December 31, 2016 – 60.6569 (as of December 31, 2015 – 72.8827).

The official RUB to Euro ("EUR") foreign exchange rates as determined by the Central Bank of the Russian Federation were as follows:

- as of September 30, 2017 – 68.4483 (as of September 30, 2016 – 70.8823);
- as of December 31, 2016 – 63.8111 (as of December 31, 2015 – 79.6972).

The average exchange rates of RUB for the nine months ended 30 September, 2017 and for the nine months ended 30 September, 2016 were:

- to US Dollar – 58.3344 and 68.3667, respectively;
- to Euro – 64.9319 and 76.2805, respectively.

## RESULTS OF OPERATION

(RUB million)

	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Sales	1,431,662	1,256,992	4,641,596	4,321,364
Net gain (loss) from trading activity	5,918	41,630	(14,409)	71,159
Operating expenses	<u>(1,226,244)</u>	<u>(1,143,971)</u>	<u>(3,931,550)</u>	<u>(3,824,703)</u>
<b>Operating profit</b>	<b>211,336</b>	<b>154,651</b>	<b>695,637</b>	<b>567,820</b>
Finance income	102,305	115,996	338,349	816,264
Finance expense	(78,710)	(132,100)	(318,337)	(499,487)
Share of net income of associates and joint ventures	27,861	21,492	83,830	55,258
Gain on disposal of available-for-sale financial assets	<u>347</u>	<u>814</u>	<u>397</u>	<u>1,835</u>
<b>Profit before profit tax</b>	<b>263,139</b>	<b>160,853</b>	<b>799,876</b>	<b>941,690</b>
Current profit tax expense	(47,657)	(28,730)	(130,819)	(134,515)
Deferred profit tax expense	<u>(7,911)</u>	<u>(20,137)</u>	<u>(53,432)</u>	<u>(69,784)</u>
Profit tax	<u>(55,568)</u>	<u>(48,867)</u>	<u>(184,251)</u>	<u>(204,299)</u>
<b>Profit for the period</b>	<b>207,571</b>	<b>111,986</b>	<b>615,625</b>	<b>737,391</b>
<b>Other comprehensive income (loss):</b>				
Items that will not be reclassified to profit or loss:				
Remeasurements of post-employment benefit obligations	<u>(44,515)</u>	<u>(13,821)</u>	<u>(58,751)</u>	<u>(92,446)</u>
<b>Total items that will not be reclassified to profit or loss</b>	<b>(44,515)</b>	<b>(13,821)</b>	<b>(58,751)</b>	<b>(92,446)</b>
Items that will be reclassified subsequently to profit or loss:				
Gain (loss) arising from change in fair value of available-for-sale financial assets, net of tax	7,138	13,487	(33,089)	34,293
Share of other comprehensive income (loss) of associates and joint ventures	356	(3,238)	2,481	(7,756)
Translation differences	(1,372)	(14,770)	21,741	(201,260)
Gain (loss) from cash flow hedges, net of tax	<u>799</u>	<u>1,742</u>	<u>(3,624)</u>	<u>41,277</u>
<b>Total items that may be reclassified subsequently to profit or loss</b>	<b>6,921</b>	<b>(2,779)</b>	<b>(12,491)</b>	<b>(133,446)</b>
<b>Other comprehensive loss for the period, net of tax</b>	<b><u>(37,594)</u></b>	<b><u>(16,600)</u></b>	<b><u>(71,242)</u></b>	<b><u>(225,892)</u></b>
<b>Total comprehensive income for the period</b>	<b>169,977</b>	<b>95,386</b>	<b>544,383</b>	<b>511,499</b>
<b>Profit for the period attributable to:</b>				
Owners of PJSC Gazprom	200,488	102,161	581,834	709,321
Non-controlling interest	<u>7,083</u>	<u>9,825</u>	<u>33,791</u>	<u>28,070</u>
	<b>207,571</b>	<b>111,986</b>	<b>615,625</b>	<b>737,391</b>
<b>Total comprehensive income for the period attributable to:</b>				
Owners of PJSC Gazprom	161,156	86,314	504,183	491,850
Non-controlling interest	<u>8,821</u>	<u>9,072</u>	<u>40,200</u>	<u>19,649</u>
	<b>169,977</b>	<b>95,386</b>	<b>544,383</b>	<b>511,499</b>

## Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
<b>Sales of gas</b>				
<i>Europe and Other countries</i>				
Gross sales <sup>(1)</sup>	628,406	530,091	1,952,011	1,930,031
Customs duties	(120,612)	(103,971)	(367,637)	(355,160)
Excise tax	(14,268)	(7,858)	(37,059)	(28,338)
Net sales	493,526	418,262	1,547,315	1,546,533
Volumes in bcm	54.7	51.5	173.8	160.9
Average price, US Dollar per mcm <sup>(2)</sup> (including excise tax and customs duties) <sup>(3)</sup>	194.6	159.2	192.8	175.9
Average price, RUB per mcm <sup>(2)</sup> (including excise tax and customs duties)	11,485.3	10,286.1	11,233.1	11,993.7
<i>Former Soviet Union countries</i>				
Gross sales <sup>(1)</sup>	55,925	51,962	223,119	234,101
Customs duties	(5,027)	(4,137)	(20,953)	(19,655)
Net sales	50,898	47,825	202,166	214,446
Volumes in bcm	5.7	5.6	24.1	22.0
Average price, US Dollar per mcm <sup>(2)</sup> (including customs duties) <sup>(3)</sup>	165.1	141.3	158.9	155.7
Average price, RUB per mcm <sup>(2)</sup> (including customs duties)	9,744.7	9,130.7	9,259.2	10,618.3
<i>Russian Federation</i>				
Gross sales (net of VAT)	121,453	110,288	587,978	530,683
Net sales	121,453	110,288	587,978	530,683
Volumes in bcm	32.9	30.0	157.0	139.7
Average price, RUB per mcm <sup>(2)</sup> (net of VAT)	3,691.7	3,677.0	3,746.2	3,797.9
<i>Total sales of gas</i>				
Gross sales (net of VAT)	805,784	692,341	2,763,108	2,694,815
Customs duties	(125,639)	(108,108)	(388,590)	(374,815)
Excise tax	(14,268)	(7,858)	(37,059)	(28,338)
Retroactive gas price adjustments	2,076	(6,227)	(5,228)	33,757
Net sales	667,953	570,148	2,332,231	2,325,419
Volumes in bcm	93.3	87.1	354.9	322.6
Net sales of refined products (net of excise tax, VAT and customs duties)	445,998	392,863	1,226,810	1,096,331
Net sales of crude oil and gas condensate (net of VAT and customs duties)	114,655	104,996	387,953	271,545
Electric and heat energy net sales (net of VAT)	86,444	86,416	349,599	322,708
Gas transportation net sales (net of VAT)	57,046	49,994	174,528	145,766
Other revenues (net of VAT)	59,566	52,575	170,475	159,595
<b>Total sales (net of excise tax, VAT and customs duties)</b>	<b>1,431,662</b>	<b>1,256,992</b>	<b>4,641,596</b>	<b>4,321,364</b>

Notes:

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

<sup>(2)</sup> One mcm is equivalent to 35,316 cubic feet.

<sup>(3)</sup> 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 320,232 million, or 7 %, to RUB 4,641,596 million for the nine months ended September 30, 2017 compared to the same period of the prior year. The increase in sales was mainly driven by an increase in sales of refined products and crude oil.

Net sales of gas for the nine months ended September 30, 2017 was 50 % of total net sales (54 % for the same period of the prior year).

Net sales of gas increased by RUB 6,812 million from RUB 2,325,419 million for the nine months ended September 30, 2016 to RUB 2,332,231 million for the nine months ended September 30, 2017.

Net sales of gas to Europe and Other countries increased by RUB 782 million, to RUB 1,547,315 million for the nine months ended September 30, 2017 compared to the same period of the prior year. The change was driven by the increase in volumes of gas sold by 8 % that was compensated by the 6 % decrease in average Russian Ruble prices (including excise tax and customs duties) for the nine months ended September 30, 2017 compared to the same period of the prior year. At the same time the average US Dollar prices increased by 10 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries decreased by RUB 12,280 million, or 6 %, to RUB 202,166 million for the nine months ended September 30, 2017 compared to the same period of the prior year. The change was due to the decrease in average Russian Ruble prices (including customs duties) by 13 % that was partially compensated by the increase in volumes of gas sold by 10 % for the nine months ended September 30, 2017.

Net sales of gas in the Russian Federation increased by RUB 57,295 million, or 11 %, to RUB 587,978 million for the nine months ended September 30, 2017 compared to the same period of the prior year. This change is mainly explained by the 12 % increase in volumes of gas sold that was partially compensated by the decrease in average Russian Ruble prices (net of VAT) by 1 %.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 130,479 million, or 12 %, to RUB 1,226,810 million for the nine months ended September 30, 2017 compared to the same period of the prior year. The increase in sales of refined products was due to an increase in average prices.

Net sales of crude oil and gas condensate (net of VAT and customs duties) increased by RUB 116,408 million, or 43 %, to RUB 387,953 million for the nine months ended September 30, 2017 compared to the same period of the prior year. The increase in sales of crude oil was due to an increase in volumes of crude oil sold by Gazprom Neft Group to customers in Europe and Other countries, which was due to crude oil production growth at Novoport, Messoyakha and Prirazlomnoye fields, decreased supplies to the refinery and increased production in Iraq and also due to an increase in average prices in all geographic segments.

## Operating expenses

Operating expenses increased by RUB 106,847 million, or 3 %, for the nine months ended September 30, 2017 to RUB 3,931,550 million in comparison with RUB 3,824,703 million for the same period of the prior year. Operating expenses as a percentage of sales decreased from 89 % for the nine months ended September 30, 2016 to 85 % for the nine months ended September 30, 2017. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Taxes other than on income	303,565	215,058	869,742	644,551
Purchased gas and oil	272,407	268,924	838,007	896,182
Staff costs	173,907	159,437	514,981	493,313
Depreciation	145,276	141,535	448,579	423,650
Transit of gas, oil and refined products	152,486	150,306	440,317	454,096
Materials	67,091	75,652	191,604	205,129
Cost of goods for resale, including refined products	57,612	57,909	170,451	133,998
Repairs and maintenance	46,383	46,798	105,566	108,626
Electricity and heating expenses	24,547	24,900	77,631	69,854
Charge for impairment and other provisions	10,355	16,129	64,559	79,553
Rental expenses	7,917	8,142	28,797	26,165
Social expenses	8,678	8,068	23,898	22,486
Insurance expenses	7,062	7,867	21,594	22,566
Transportation services	4,335	7,091	20,071	22,899
Processing services	4,338	3,822	11,789	11,643
Research and development expenses	4,029	11,628	10,236	24,704
Foreign exchange rate differences on operating items	(594)	(49,437)	(9,354)	13,882
Derivatives (gain) loss	(4,348)	648	(11,699)	10,851
Other	95,599	75,095	273,481	225,402
	<b>1,380,645</b>	<b>1,229,572</b>	<b>4,090,250</b>	<b>3,889,550</b>
Changes in inventories of finished goods, work in progress and other effects	(154,401)	(85,601)	(158,700)	(64,847)
<b>Total operating expenses</b>	<b>1,226,244</b>	<b>1,143,971</b>	<b>3,931,550</b>	<b>3,824,703</b>

### *Taxes other than on income*

Taxes other than on income consist of:

(RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Mineral extraction tax	215,495	140,457	622,044	431,034
Excise tax	45,536	40,746	120,127	106,682
Property tax	37,938	31,241	118,555	95,526
Other taxes	4,596	2,614	9,016	11,309
<b>Taxes other than on income</b>	<b>303,565</b>	<b>215,058</b>	<b>869,742</b>	<b>644,551</b>

Mineral extraction tax increased by RUB 191,010 million, or 44 %, to RUB 622,044 million for the nine months ended September 30, 2017 compared to RUB 431,034 million for the same period of the prior year, mainly as a result of changes in the elements of the natural gas and crude oil MET formulas introduced with effect from 1 January 2017.

Property tax increased by RUB 23,029 million, or 24 %, to RUB 118,555 million for the nine months ended September 30, 2017 compared to RUB 95,526 million for the same period of the prior year mainly due to the revaluation of fixed assets as of December 31, 2016.

### *Purchased gas and oil*

Cost of purchased gas and oil decreased by RUB 58,175 million, or 6 %, to RUB 838,007 million for the nine months ended September 30, 2017 compared to RUB 896,182 million for the same period of the prior year.

Cost of purchased gas decreased by RUB 99,199 million, or 14 %, to RUB 599,201 million for the nine months ended September 30, 2017 compared to RUB 698,400 million for the same period of the prior year. This decrease was mainly due to a decrease in purchases of gas of GAZPROM Germania Group in Russian Ruble terms, as well as to an insignificant decrease in the volumes of gas purchased from external suppliers.

Cost of purchased oil included in the purchased gas and oil increased by RUB 41,024 million, or 21 %, to RUB 238,806 million for the nine months ended September 30, 2017 compared to RUB 197,782 million for the same period of the prior year. This change was mainly related to an increase in prices of oil.

#### *Transit of gas, oil and refined products*

Transit of gas, oil and refined products expenses decreased by RUB 13,779 million, or 3 %, to RUB 440,317 million for the nine months ended September 30, 2017 compared to RUB 454,096 million for the same period of the prior year. This decrease was mainly due to a decrease in transit of gas, oil and refined products expenses in Russian Ruble terms.

#### *Cost of goods for resale, including refined products*

Cost of goods for resale, including refined products increased by RUB 36,453 million, or 27 %, to RUB 170,451 million for the nine months ended September 30, 2017 compared to RUB 133,998 million for the same period of the prior year. The increase was mainly due to increased volumes of petroleum products purchases (connected with a refining decline) in Gazprom Neft Group.

#### *Charge for impairment and other provisions*

Charge for impairment and other provisions of the Group decreased by RUB 14,994 million, or 19 %, to RUB 64,559 million for the nine months ended September 30, 2017 compared to RUB 79,553 million for the same period of the prior year. The change was mainly driven by a decrease in charges for impairment allowance for doubtful accounts receivable for JSC Moldovagaz for the nine months ended September 30, 2017 compared to the charges for impairment allowance for the same period of the prior year.

#### *Foreign exchange rate differences on operating items*

Foreign exchange rate gain on operating items amounted to RUB 9,354 million for the nine months ended September 30, 2017 compared to a foreign exchange rate loss of RUB 13,882 million for the same period of the prior year. This change was mainly explained by the depreciation of US Dollar against the Russian Ruble by 4 % and by the appreciation of Euro against the Russian Ruble by 7 % for the nine months ended September 30, 2017 compared to a depreciation of US Dollar and Euro against the Russian Ruble by 13 % and 11 %, respectively, for the same period of the prior year.

### **Operating profit**

As a result of the factors discussed above, operating profit increased by RUB 127,817 million, or 23 %, to RUB 695,637 million for the nine months ended September 30, 2017 from RUB 567,820 million for the same period of the prior year. The operating profit margin increased from 13 % for the nine months ended September 30, 2016 to 15 % for the nine months ended September 30, 2017.

### **Net finance income (expense)**

(RUB million)	Three months ended September 30,		Nine months ended September 30,	
	2017	2016	2017	2016
Foreign exchange gain	81,564	95,597	272,945	741,229
Foreign exchange loss	<u>(70,931)</u>	<u>(115,809)</u>	<u>(279,615)</u>	<u>(447,087)</u>
Net exchange gain (loss)	10,633	(20,212)	(6,670)	294,142
Interest income	20,741	20,399	65,404	75,035
Interest expense	<u>(7,779)</u>	<u>(16,291)</u>	<u>(38,722)</u>	<u>(52,400)</u>
<b>Net finance income (expense)</b>	<b>23,595</b>	<b>(16,104)</b>	<b>20,012</b>	<b>316,777</b>

The net foreign exchange loss of RUB 6,670 million and the net foreign exchange gain of RUB 294,142 million for the nine months ended September 30, 2017 and 2016, respectively, were explained by the depreciation of US Dollar against the Russian Ruble by 4 % and by the appreciation of Euro against the Russian Ruble by 7 % for the nine months ended September 30, 2017 compared to a depreciation of US Dollar and Euro against the Russian Ruble by 13 % and 11 %, respectively, for the same period of the prior year.

Interest income decreased by RUB 9,631 million, or 13 %, to RUB 65,404 million for the nine months ended September 30, 2017 from RUB 75,035 million for the same period of the prior year.

Interest expense decreased by RUB 13,678 million, or 26 %, to RUB 38,722 million for the nine months ended September 30, 2017 compared to RUB 52,400 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 increased by RUB 28,572 million, or 52 %, to RUB 83,830 million for the nine months ended September 30, 2017 compared to RUB 55,258 million for the same period of the prior year. This change was mainly caused by the increase in the share of net income of Sakhalin Energy Investment Company Ltd.

## Profit tax

Total profit tax decreased by RUB 20,048 million, or 10 %, to RUB 184,251 million for the nine months ended September 30, 2017 compared to RUB 204,299 million for the same period of the prior year. The effective profit tax rate was 23.0 % and 21.7 % for the nine months ended September 30, 2017 and 2016, respectively.

## 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 127,487 million, or 18 %, from RUB 709,321 million for the nine months ended September 30, 2016 to RUB 581,834 million for the nine months ended September 30, 2017.

## Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 5,721 million, or 20 %, to RUB 33,791 million for the nine months ended September 30, 2017 compared to RUB 28,070 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, 2017 and 2016:

(RUB million)	Nine months ended September 30,	
	2017	2016
Net cash from operating activities	612,817	1,176,475
Net cash used in investing activities	(1,083,937)	(1,187,685)
Net cash from (used in) financing activities	62,572	(459,559)

### *Net cash from operating activities*

Net cash from operating activities decreased by RUB 563,658 million, or 48 %, to RUB 612,817 million for the nine months ended September 30, 2017 compared to RUB 1,176,475 million for the same period of the prior year. This change was mainly driven by a replace of cash on short-term deposits included within other current assets.

### *Net cash used in investing activities*

Net cash used in investing activities decreased by RUB 103,748 million, or 9 %, to RUB 1,083,937 million for the nine months ended September 30, 2017 compared to RUB 1,187,685 million for the same period of the prior year. The change was mainly due to a decrease in cash used for capital expenditures, which was driven by a change in the approach to reflect this flow in the end of 2016. The change in the approach was caused by applying by the Group of Agency agreements for the implementation of investment projects on intercompany transactions. The new approach allowed to speed up the process of VAT refunding from the budget. Based on the changed nature of the settlement transactions with the budget for VAT, the Group made a decision to reflect cash flows for VAT payments as payments to the budget as part of operating activities.

### *Net cash from (used in) financing activities*

Net cash from financing activities amounted to RUB 62,572 million for the nine months ended September 30, 2017 compared to net cash used in financing activities of RUB 459,559 million for the same period of the prior year. This change was mainly due to an increase in proceeds from borrowings.

## Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segments for the nine months ended September 30, 2017 and 2016 in Russian Ruble terms amounted to the following:

(RUB million)	Nine months ended September 30,	
	2017	2016
Transportation	305,012	205,568
Production of crude oil and gas condensate	194,635	231,200
Refining	135,645	94,104
Production of gas	107,695	141,645
Electric and heat energy generation and sales	26,192	44,996
Distribution of gas	19,094	21,224
Gas storage	12,335	24,334
All other segments	<u>73,374</u>	<u>39,303</u>
<b>Total</b>	<b>873,982</b>	<b>802,374</b>

Total capital expenditures increased by RUB 71,608 million, or 9 %, from RUB 802,374 million for the nine months ended September 30, 2016 to RUB 873,982 million for the nine months ended September 30, 2017.

## 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 705,861 million, or 37 %, from RUB 1,932,895 million as of December 31, 2016 to RUB 2,638,756 million as of September 30, 2017. This increase was due to an increase in borrowings and a decrease in cash and cash equivalents. A decrease of cash balances was due to an increase of deposits in the amount of RUB 323,576 million for the nine months ended 30 September, 2017.