

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

You should read the following management's discussion in conjunction with our unaudited consolidated interim condensed financial information as of and for the nine months ended September 30, 2012. The consolidated interim condensed financial information has been prepared in accordance with International Accounting Standard 34 "Interim financial reporting" ("IAS 34"). This financial information should be read together with the consolidated financial statements for the year ended December 31, 2011, 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, production and market capitalization. Our revenues are primarily derived from sales of natural gas, crude oil and other hydrocarbon products to Western and Central Europe, Russia and other former Soviet Union countries.

We divide our operations into the following principal businesses:

- Production of gas – exploration and production of gas;
- Transport – transportation of gas;
- Distribution – sales of gas within 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; and
- Electric and heat energy generation and sales.

Other businesses primarily comprise production of other products and sales of several goods, works, services.

Our main business 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, our Distribution segment purchases natural gas from our Production of gas segment and transportation services from our Transport segment. Our Refining segment purchases gas from our 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 was a stand-alone business. For this reason, we do not analyze any of our main segments separately in the discussion that follows.

RESULTS OF OPERATIONS

(RUB million)

	Nine months periods ended September 30,	
	2012	2011
Sales	3,351,303	3,296,656
Net gain (loss) from trading activity	5,798	(837)
Operating expenses	<u>(2,491,733)</u>	<u>(2,119,289)</u>
Operating profit	865,368	1,176,530
Finance income	252,733	117,012
Finance expense	(204,539)	(192,323)
Share of net income of associated undertakings and jointly controlled entities	126,690	71,779
(Losses) gains on disposal of available-for-sale financial assets	<u>(35)</u>	<u>841</u>
Profit before profit tax	1,040,217	1,173,839
Current profit tax expense	(208,974)	(198,969)
Deferred profit tax benefit (expense)	<u>1,882</u>	<u>(34,043)</u>
Profit tax expense	(207,092)	(233,012)
Profit for the period	833,125	940,827
Other comprehensive income		
Losses arising from change in fair value of available-for-sale financial assets, net of tax	(13,424)	(20,100)
Share of other comprehensive loss of associated undertakings and jointly controlled entities	(8,919)	(6,854)
Translation differences	(20,679)	23,373
Losses from cash flow hedges, net of tax	<u>(2,518)</u>	<u>-</u>
Other comprehensive loss for the period, net of tax	(45,540)	(3,581)
Total comprehensive income for the period	787,585	937,246
Profit attributable to:		
owners of OAO Gazprom	813,721	923,647
non-controlling interest	<u>19,404</u>	<u>17,180</u>
	833,125	940,827
Total comprehensive income attributable to:		
owners of OAO Gazprom	769,160	918,731
non-controlling interest	<u>18,425</u>	<u>18,515</u>
	787,585	937,246

Sales

The following table sets out our volumes and realized prices for the nine months periods ended September 30, 2012 and 2011.

(RUB million unless indicated otherwise)	Nine months periods ended September 30,	
	2012	2011
Sales of gas		
<i>Europe and other countries</i>		
Gross sales ⁽¹⁾	1,312,759	1,241,720
Customs duties	(243,944)	(215,269)
Net sales	1,068,815	1,026,451
Volumes in billion cubic meters (bcm)	111.4	114.8
Gross average price, U.S.\$ per mcm ⁽²⁾ (including customs duties) ⁽³⁾	379.0	376.0
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	11,781.1	10,815.6
<i>FSU (Former Soviet Union)</i>		
Gross sales ⁽¹⁾	456,715	496,134
Customs duties	(71,071)	(37,526)
Net sales	385,644	458,608
Volumes in bcm	47.9	62.5
Gross average price, U.S.\$ per mcm ⁽²⁾ (including customs duties) ⁽³⁾	306.6	276.1
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	9,531.0	7,942.5
<i>Russian Federation</i>		
Gross sales (net of VAT)	508,123	502,271
Net sales	508,123	502,271
Volumes in bcm	183.0	194.5
Gross average price, RUB per mcm ⁽²⁾ (net of VAT)	2,776.5	2,583.0
<i>Total sales of gas</i>		
Gross sales (net of VAT)	2,277,597	2,240,125
Customs duties	(315,015)	(252,795)
Effect of retroactive gas price adjustments	(133,186)	-
Net sales	1,829,396	1,987,330
Volumes in bcm	342.3	371.8
Net sales of refined products (net of excise tax, VAT and customs duties)	873,583	717,723
Net sales of crude oil and gas condensate (net of VAT and customs duties)	200,269	164,438
Net sales of electric and heat energy (net of VAT)	243,745	237,545
Gas transportation net sales (net of VAT)	90,314	82,501
Other revenues (net of VAT)	<u>113,996</u>	<u>107,119</u>
Total sales (net of excise tax, VAT and customs duties)	<u>3,351,303</u>	<u>3,296,656</u>

Notes:

⁽¹⁾ VAT is not charged on sales to Europe and other countries and former Soviet Union countries.

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

⁽³⁾ Calculated on the basis of average rate between RUB and U.S.\$.

Total sales (net of VAT, excise tax and customs duties) increased by RUB 54,647 million, or 2%, to RUB 3,351,303 million in the nine months periods ended September 30, 2012 compared to the same period of the prior year.

Net sales of gas accounted for 55% and 60% of total net sales in the nine months periods ended September 30, 2012 and 2011, respectively.

Net sales of gas decreased from RUB 1,987,330 million in the nine months period ended September 30, 2011 to RUB 1,829,396 million in the nine months period ended September 30, 2012, or by 8%.

Net sales of gas to Europe and other countries increased in the nine months period ended September 30, 2012 compared to the nine months period ended September 30, 2011, by RUB 42,364 million, to RUB 1,068,815 million.

The overall increase in net sales of gas to Europe and other countries relates to increase of gross average RUB price (including customs duties) by 9%. The volume of gas sold decreased by 3% in the nine months period ended September 30, 2012, compared to the nine months period ended September 30, 2011.

During the year 2012 the Group recognized the effect of renegotiated prices for long-term gas supply contracts related to gas deliveries in the years 2010 and 2011. Retroactive gas price adjustments were recognized in financial statements as decrease of sales in the amount of RUB 133,186 million.

Net sales of gas to FSU countries decreased in the nine months period ended September 30, 2012 compared to the nine months period ended September 30, 2011, by RUB 72,964 million, or 16%, to RUB 385,644 million. This decrease was mainly due to the decrease in volumes of gas sold to FSU countries by 23% in the nine months period ended September 30, 2012 compared to the nine months period ended September 30, 2011. The gross average RUB price (including customs duties) increased by 20% in nine months period ended September 30, 2012 compared to the same period of the prior year.

Net sales of gas in the Russian Federation increased in the nine months period ended September 30, 2012 compared to the same period of the prior year, by RUB 5,852 million, or 1%, to RUB 508,123 million. The gross average price for domestic gas sales increased by 7% in nine months period ended September 30, 2012 compared to the same period of the prior year. The volume of gas sold in the nine months period ended September 30, 2012 decreased by 6%, compared to the nine months period ended September 30, 2011.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 155,860 million, or 22%, to RUB 873,583 million in nine months period ended September 30, 2012 in comparison with the same period of the prior year. The increase mainly resulted from the increase in prices for refined products and increase in volumes sold in nine months period ended September 30, 2012 compared to the same period of the prior year. In the nine months period ended September 30, 2012 and 2011 Gazprom Neft Group's sales comprised 80% and 85% of the total amount of our net sales of refined products, respectively.

Net sales of crude oil and gas condensate (net of VAT and customs duties) increased by RUB 35,831 million, or 22%, to RUB 200,269 million in the nine months period ended September 30, 2012 compared to RUB 164,438 million in the nine months period ended September 30, 2011. The increase was mainly caused by the increase in oil prices and volumes of oil sold in the nine months period ended September 30, 2012 compared to the same period of the prior year. Sales of crude oil included in net sales of crude oil and gas condensate (net of VAT and customs duties), amounted to RUB 167,579 million and RUB 133,368 million in the nine months period ended September 30, 2012 and 2011, respectively.

Net sales of electric and heat energy (net of VAT) increased by RUB 6,200 million, or 3%, to RUB 243,745 million in the nine months period ended September 30, 2012 compared to the same period of the prior year. The growth was mainly caused by expanding of Gazprom Group's scope of consolidation, and partially mitigated by decrease in revenues from electric and heat energy sales due to reduction of electricity prices at the day-ahead market and decrease in sales volumes of electric and heat energy during six months ended June 30, 2012.

Gas transportation net sales (net of VAT) increased by RUB 7,813 million, or 9%, to RUB 90,314 million in the nine months period ended September 30, 2012 from RUB 82,501 million in the nine months period ended September 30, 2011. The increase was mainly caused by the increase in volume of gas transportation services rendered to independent gas suppliers in the nine months period ended September 30, 2012 compared to the same period of the prior year.

Other revenues increased by RUB 6,877 million, or 6%, to RUB 113,996 million in the nine months period ended September 30, 2012 compared to RUB 107,119 million in the nine months period ended September 30, 2011.

Operating expenses

Operating expenses increased by 18% in the nine months period ended September 30, 2012 to RUB 2,491,733 million from RUB 2,119,289 million in the nine months period ended September 30, 2011. Operating expenses as a percentage of sales increased from 64% in the nine months period ended September 30, 2011 to 74% in the nine months period ended September 30, 2012. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Nine months periods ended	
	September 30,	
	2012	2011
Purchased gas and oil	666,983	628,590
Taxes other than on income	434,079	310,268
Staff costs	305,514	267,377
Depreciation	242,099	201,636
Transit of gas, oil and refined products	237,802	197,740
Repairs and maintenance	137,410	127,583
Materials	100,334	76,595
Cost of goods for resale, including refined products	87,009	77,676
Electricity and heating expenses	53,147	54,192
Charge for impairment provisions	32,147	11,527
Transportation services	25,799	24,205
Research and development expenses	17,191	14,667
Heat transmission	16,951	17,885
Insurance expenses	16,023	13,737
Social expenses	15,400	22,078
Rental expenses	15,351	20,339
Processing services	10,514	6,496
Losses (gains) from derivative financial instruments	8,912	(1,258)
Exchange rate differences on operating items	4,266	(3,883)
Other	<u>154,891</u>	<u>125,222</u>
	<u>2,581,822</u>	<u>2,192,672</u>
Changes in inventories of finished goods, work in progress and other effects	<u>(90,089)</u>	<u>(73,383)</u>
Total operating expenses	<u>2,491,733</u>	<u>2,119,289</u>

Purchased gas and oil

Cost of purchased gas and oil increased by 6% to RUB 666,983 million in the nine months period ended September 30, 2012 from RUB 628,590 million in the nine months period ended September 30, 2011. Cost of purchased gas decreased by RUB 35,030 million, or 8%. This decrease relates to the decrease in volumes of gas purchased and prices for gas purchased from third parties outside the Russian Federation. The cost of purchased oil included in the cost of purchased gas and oil increased by RUB 73,423 million, or 39%, and amounted to RUB 259,932 million in the nine months period ended September 30, 2012 in comparison with RUB 186,509 million in the nine months period ended September 30, 2011 due to increase both in volumes and prices of oil purchased.

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Nine months periods ended September 30,	
	2012	2011
Natural resources production tax	304,636	194,051
Property tax	41,915	34,954
Other taxes	<u>87,528</u>	<u>81,263</u>
Taxes other than on income	434,079	310,268

The natural resources production tax increased by 57% to RUB 304,636 million in the nine months period ended September 30, 2012 from RUB 194,051 million in the nine months period ended September 30, 2011. The increase mainly resulted from the general increase of natural resources production tax rate for gas from RUB 237 to RUB 509 per thousand cubic meters from January 1, 2012 as well as from the increase in volumes of oil extraction along with increase of natural resources production tax rate for oil.

Staff costs

Staff costs increased by 14% to RUB 305,514 million in the nine months period ended September 30, 2012 from RUB 267,377 million in the nine months period ended September 30, 2011. The increase mainly resulted from salary indexation and expansion of Gazprom Group's scope of consolidation.

Depreciation

Depreciation increased by 20%, or RUB 40,463 million, to RUB 242,099 million in the nine months period ended September 30, 2012 from RUB 201,636 million in the nine months period ended September 30, 2011. The increase primarily relates to the growth in fixed asset base.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 20% to RUB 237,802 million in the nine months period ended September 30, 2012 from RUB 197,740 million in the nine months period ended September 30, 2011. This increase mainly relates to the increase in costs of transportation through Ukraine and through the "Nord Stream" pipeline.

Repairs and maintenance

Cost of repairs and maintenance increased by 8% to RUB 137,410 million in nine months period ended September 30, 2012 from RUB 127,583 million in the nine months period ended September 30, 2011. This increase was caused by the increase in volume of repair services rendered by third parties to the Group in the nine months period ended September 30, 2012.

Materials

Cost of materials increased by 31% to RUB 100,334 million in the nine months period ended September 30, 2012 from RUB 76,595 million in the nine months period ended September 30, 2011. The increase mainly resulted from the expanding of Gazprom Group's scope of consolidation and the increase in prices.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products increased by 12% to RUB 87,009 million in the nine months period ended September 30, 2012 from RUB 77,676 million in the nine months period ended September 30, 2011. The increase in cost of goods for resale, including refined products, mainly results from the increase in volumes of refined products purchased by the Gazprom Neft Group, expanding of Gazprom Group's scope of consolidation and the increase in prices for refined products.

Electricity and heating expenses

Electricity and heating expenses decreased by 2% to RUB 53,147 million in the nine months period ended September 30, 2012 from RUB 54,192 million in the nine months period ended September 30, 2011. The decrease mainly resulted from the decrease in volumes of electricity purchased from third parties.

Losses (gains) from derivative financial instruments

Derivative financial instruments of the Group are primarily represented by commodity contracts to sell gas to third parties which are marked to market. Derivative loss is caused by the significant market gas prices increase for the nine months ended September 30, 2012 comparing to relatively stable market gas prices for the nine months ended September 30, 2011.

Exchange rate differences on operating items

Exchange rate differences on operating items in the nine months periods ended September 30, 2012 and 2011 amounted to a net loss of RUB 4,266 million and gain of RUB 3,883 million, respectively. The change was primarily driven by depreciation of both USD and euro against RUB by 4% in the nine months period ended September 30, 2012, compared to appreciation of USD and euro against RUB by 5% and 8% in the same period of the prior year, respectively.

Other operating expenses

Other operating expenses increased by 24% to RUB 154,891 million in the nine months period ended September 30, 2012 from RUB 125,222 million in the nine months period ended September 30, 2011. Other expenses include bank charges, security services, legal and consulting services, charity and finance aid, advertising and software services.

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 23% to RUB 90,089 million in the nine months period ended September 30, 2012. The negative amount of changes in inventory of finished goods, work in progress and other effects in the nine months period, ended September 30, 2012 relates mainly to the increase in the balances of finished goods as of September 30, 2012 in comparison with those as of December 31, 2011.

Operating profit

As a result of the factors discussed above, our operating profit decreased by RUB 311,162 million, or 26%, to RUB 865,368 million in the nine months period ended September 30, 2012 from RUB 1,176,530 million in the same period of the prior year. Our operating profit margin decreased from 36% in the nine months period ended September 30, 2011 to 26% in the nine months period ended September 30, 2012.

Net finance income (expense)

(RUB million)	Nine months periods ended	
	September 30, 2012	2011
Exchange gains	232,553	103,368
Exchange losses	(178,464)	(171,031)
Net exchange (loss) gain	54,089	(67,663)
Interest income	20,173	13,452
Interest expense	(26,075)	(21,292)
Gains on extinguishment of restructured liabilities	7	192
Net finance income (expense)	48,194	(75,311)

Exchange gains increased by RUB 129,185 million to RUB 232,553 million in the nine months period ended September 30, 2012 from RUB 103,368 million in the same period of the prior year. Exchange losses increased by RUB 7,433 million to RUB 178,464 million in the nine months period ended September 30, 2012 from RUB 171,031 million in the same period of the prior year. The net exchange gain of RUB 54,089 million in the nine months period ended September 30, 2012 in comparison with net exchange loss of RUB 67,663 million in the same

period of the prior year is explained by depreciation of both USD and euro against RUB by 4% in the nine months period ended September 30, 2012, compared to appreciation of USD and euro against RUB by 5% and 8% in the same period of the prior year, respectively.

Interest income increased by 50% to RUB 20,173 million in the nine months period ended September 30, 2012 from RUB 13,452 million in the same period of the prior year, mainly due to increase of interest accrued on Group's cash held with banks and consolidation of new companies.

Interest expense increased by 22% to RUB 26,075 million in the nine months period ended September 30, 2012 from RUB 21,292 million in the same period of the prior year, mainly due to increase in average borrowings balance during the nine months period ended September 30, 2012 in comparison with the same period of the prior year.

Share of net income of associated undertakings and jointly controlled entities

Share of net income of associated undertakings and jointly controlled entities increased by RUB 54,911 million, or 77%, to RUB 126,690 million in the nine months period ended September 30, 2012 compared to RUB 71,779 million in the same period of the prior year. The increase of the Group's share of net income of associated undertakings and jointly controlled entities in the nine months period ended September 30, 2012 relates mainly to the recognition of share in net income of RosUkrEnergO AG for 2011 triggered by the receipt of dividends in July 2012; increase in net income of Sakhalin Energy Investment Company Ltd. due to the growth of liquefied natural gas sales; increase in net income of Salym Petroleum Development N.V., OAO Tomskneft VNK and its subsidiaries and OAO NGK Slavneft and its subsidiaries caused by the growth of oil prices.

Profit tax

Total profit tax expense decreased by RUB 25,920 million, or 11%, to RUB 207,092 million in the nine months period ended September 30, 2012 compared to RUB 233,012 million in the nine months period ended September 30, 2011. The effective profit tax rate was 19.9% in the nine months periods ended September 30, 2012 and 2011.

Profit for the period attributable to owners of OAO Gazprom

As a result of the factors discussed above, our profit for the period attributable to owners of OAO Gazprom decreased by RUB 109,926 million, or 12%, from RUB 923,647 million in the nine months period ended September 30, 2011 to RUB 813,721 million in the nine months period ended September 30, 2012.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 2,224 million, or 13%, to RUB 19,404 million in the nine months period ended September 30, 2012 compared to RUB 17,180 million in the nine months period ended September 30, 2011.

LIQUIDITY AND CAPITAL RESOURCES

The following table summarizes our statements of cash flows for the nine months ended September 30, 2012 and 2011:

(RUB million)	Nine months periods ended	
	September 30,	
	2012	2011
Net cash provided by operating activities	983,391	1,067,752
Net cash used for investing activities	(882,946)	(1,069,354)
Net cash used for financing activities	(121,933)	(58,652)

Net cash provided by operating activities

Net cash provided by operating activities amounted to RUB 983,391 million in the nine months period ended September 30, 2012 compared to RUB 1,067,752 million in the nine months period ended September 30, 2011. The decrease was primarily due to the decrease in profit before profit tax caused by increase in share of operating expenses in total sales in the nine months period ended September 30, 2012 in comparison with the same period of the prior year.

Net cash used for investing activities

Net cash used for investing activities decreased by RUB 186,408 million, or 17%, to RUB 882,946 million in the nine months period ended September 30, 2012 compared to RUB 1,069,354 million in the nine months period ended September 30, 2011. The decrease was primarily due to the decrease in total cash outflow related to capital expenditures and increase in proceeds from associated undertakings and jointly controlled entities in the nine months period ended September 30, 2012 in comparison with the same period of the prior year.

Net cash used for financing activities

Net cash used for financing activities amounted to RUB 121,933 million in the nine months period ended September 30, 2012 compared to RUB 58,652 million in the nine months period ended September 30, 2011. This change was mainly due to the increase in dividends paid in the nine months period ended September 30, 2012 compared to the same period of the prior year. This effect was partly offset by the decrease in repayment of long-term borrowings in the nine months period ended September 30, 2012 in comparison with the same period of the prior year.

CAPITAL EXPENDITURES

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the nine months periods ended September 30, 2012 and 2011 in nominal RUB terms, amounted to the following:

(RUB million)	Nine months periods ended September 30,	
	2012	2011
Transport	462,711	446,273
Production of gas	193,442	179,189
Refining	97,536	75,236
Production of crude oil and gas condensate	88,762	62,519
Electric and heat energy generation and sales	36,225	51,004
Distribution	34,135	24,626
Gas storage	12,863	10,764
All other segments	<u>10,687</u>	<u>22,966</u>
Total	936,361	872,577

Note:

(1) The capital expenditures in the present analysis differ from the capital additions disclosed within the Group's business segments in IFRS consolidated interim condensed financial information of OAO Gazprom primarily due to VAT.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RUB 63,784 million, or 7%, from RUB 872,577 million in the nine months period ended September 30, 2011 to RUB 936,361 million in the nine months period ended September 30, 2012.

The increase of capital expenditures in the Transport segment was primarily due to increased capital expenditure on the construction of major transportation projects, including Pipeline Bovanenkovo-Ukhta, Pipeline Ukhta-Torzhek, Nord Stream and Sakhalin-Khabarovsk-Vladivostok. The increase of capital expenditures in the Production of gas segment was primarily due to increased capital expenditures for infrastructure development performed at Bovanenkovskoe field. The increase of our capital expenditures in the Refining segment was primarily due to increased capital expenditures of Gazprom Neft Group and OOO Novourengoysky GCC. The increase of our capital expenditures in the Production of crude oil and gas condensate segment was primarily due to increased capital expenditures of Gazprom Neft Group.

DEBT OBLIGATIONS

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 122,819 million, or 12%, from RUB 1,034,941 million as of December 31, 2011 to RUB 1,157,760 million as of September 30, 2012. This increase resulted mainly from raising of new long-term borrowings and decrease in cash and cash equivalents.