

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 three months ended March 31, 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 three months ended March 31, 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)

	Three months ended March 31,	
	2016	2015
Sales	1,737,364	1,648,253
Net gain (loss) from trading activity	18,508	(18,013)
Operating expenses	<u>(1,453,899)</u>	<u>(1,171,585)</u>
Operating profit	301,973	458,655
Finance income	403,339	683,675
Finance expense	(236,552)	(683,588)
Share of net income of associates and joint ventures	12,845	37,314
Gains on disposal of available-for-sale financial assets	<u>355</u>	<u>38</u>
Profit before profit tax	481,960	496,094
Current profit tax expense	(71,514)	(74,584)
Deferred profit tax expense	<u>(37,105)</u>	<u>(31,892)</u>
Profit tax expense	(108,619)	(106,476)
Profit for the period	373,341	389,618
Other comprehensive income (loss):		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(30,781)</u>	<u>(54,348)</u>
Total items that will not be reclassified to profit or loss	(30,781)	(54,348)
Items that will be reclassified subsequently to profit or loss:		
Gains arising from change in fair value of available-for-sale financial assets, net of tax	4,391	598
Share of other comprehensive (loss) income of associates and joint ventures	(3,557)	4,117
Translation differences	(97,948)	(10,826)
Gains from cash flow hedges, net of tax	<u>26,775</u>	<u>2,770</u>
Total items that may be reclassified subsequently to profit or loss	(70,339)	(3,341)
Other comprehensive loss for the period, net of tax	<u>(101,120)</u>	<u>(57,689)</u>
Total comprehensive income for the period	272,221	331,929
Profit for the period attributable to:		
Owners of PJSC Gazprom	362,309	382,112
Non-controlling interest	<u>11,032</u>	<u>7,506</u>
	373,341	389,618
Total comprehensive income for the period attributable to:		
Owners of PJSC Gazprom	265,181	328,199
Non-controlling interest	<u>7,040</u>	<u>3,730</u>
	272,221	331,929

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Three months ended March 31,	
	2016	2015
Sales of gas		
<i>Europe and Other countries</i>		
Gross sales ⁽¹⁾	815,958	702,703
Customs duties	(140,029)	(131,498)
Excise tax	(12,753)	(28,212)
Net sales	663,176	542,993
Volumes in bcm	58.1	39.1
Gross average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	187.5	284.2
Gross average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	14,049.3	17,959.1
<i>Former Soviet Union countries</i>		
Gross sales ⁽¹⁾	127,934	173,808
Customs duties	(10,999)	(18,170)
Net sales	116,935	155,638
Volumes in bcm	10.9	12.9
Gross average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	156.7	212.5
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	11,741.3	13,427.7
<i>Russian Federation</i>		
Gross sales (net of VAT)	291,850	286,553
Net sales	291,850	286,553
Volumes in bcm	75.4	80.3
Gross average price, RUB per mcm ⁽²⁾ (net of VAT)	3,872.9	3,567.7
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,235,742	1,163,064
Customs duties	(151,028)	(149,668)
Excise tax	(12,753)	(28,212)
Retroactive gas price adjustments	893	16,425
Net sales	1,072,854	1,001,609
Volumes in bcm	144.4	132.3
Net sales of refined products (net of excise tax, VAT and customs duties)	337,940	364,681
Electric and heat energy net sales (net of VAT)	147,570	133,204
Net sales of crude oil and gas condensate (net of VAT and customs duties)	75,529	59,511
Gas transportation net sales (net of VAT)	47,596	44,507
Other revenues (net of VAT)	<u>55,875</u>	<u>44,741</u>
Total sales (net of excise tax, VAT and customs duties)	<u>1,737,364</u>	<u>1,648,253</u>

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 89,111 million, or 5 %, to RUB 1,737,364 million for the three months ended March 31, 2016 compared to the same period of the prior year. The increase in sales was mainly driven by an increase in sales of gas to Europe and Other countries.

Net sales of gas accounted for 62 % of total net sales for the three months ended March 31, 2016 (61 % for the same period of the prior year).

Net sales of gas increased by RUB 71,245 million, or 7 %, from RUB 1,001,609 million for the three months ended March 31, 2015 to RUB 1,072,854 million for the three months ended March 31, 2016.

Net sales of gas to Europe and Other countries increased by RUB 120,183 million, or 22 %, to RUB 663,176 million for the three months ended March 31, 2016 compared to the same period of the prior year. The overall increase in sales of gas to Europe and Other countries was driven by the 49 % increase in volumes of gas sold for the three months ended March 31, 2016 compared to the same period of the prior year. At the same time gross average Russian Ruble prices (including excise tax and customs duties) decreased by 22 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries decreased by RUB 38,703 million, or 25 %, to RUB 116,935 million for the three months ended March 31, 2016 compared to the same period of the prior year. The change was due to the 16 % decrease in volumes of gas sold and the decrease in gross average Russian Ruble prices (including customs duties) by 13 % for the three months ended March 31, 2016.

Net sales of gas in the Russian Federation increased by RUB 5,297 million, or 2 %, to RUB 291,850 million for the three months ended March 31, 2016 compared to the same period of the prior year. This is primarily explained by the increase in the average Russian Ruble price (net of VAT) by 9 % for the three months ended March 31, 2016 compared to the same period of the prior year. At the same time volumes of gas sold decreased by 6 %.

Operating expenses

Operating expenses increased by 24 % for the three months ended March 31, 2016 to RUB 1,453,899 million from RUB 1,171,585 million for the same period of the prior year. Operating expenses as a percentage of sales increased from 71 % for the three months ended March 31, 2015 to 84 % for the three months ended March 31, 2016. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Three months ended March 31,	
	2016	2015
Purchased gas and oil	345,940	207,136
Taxes other than on income	217,658	234,139
Staff costs	170,085	145,097
Transit of gas, oil and refined products	165,910	124,604
Depreciation	141,948	124,271
Materials	59,631	57,743
Charge for impairment provisions	48,149	29,713
Foreign exchange rate differences on operating items	42,655	17,444
Cost of goods for resale, including refined products	31,415	41,839
Electricity and heating expenses	23,579	25,511
Repairs and maintenance	19,511	20,026
Rental expenses	8,881	9,163
Research and development expenses	7,275	5,610
Insurance expenses	7,256	7,265
Transportation services	7,188	8,244
Social expenses	6,446	5,463
Processing services	4,325	4,703
Derivatives gains	(7,775)	(14,290)
Other	62,874	90,333
	<u>1,362,951</u>	<u>1,144,014</u>
Changes in inventories of finished goods, work in progress and other effects	90,948	27,571
Total operating expenses	1,453,899	1,171,585

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 138,804 million to RUB 345,940 million for the three months ended March 31, 2016 compared to RUB 207,136 million for the same period of the prior year.

Cost of purchased gas increased by RUB 130,192 million, or 81 %, to RUB 291,579 million for the three months ended March 31, 2016 compared to RUB 161,387 million for the same period of the prior year. This increase was related to the completion of the Swap Agreement between PJSC Gazprom and Wintershall Holding GmbH which resulted in acquisition of control over W & G Beteiligungs-GmbH & Co. KG and WIEH GmbH & Co. KG and their subsidiaries which operate as natural gas trading and storage companies.

Cost of purchased oil included in the purchased gas and oil increased by RUB 8,612 million, or 19 %, to RUB 54,361 million for the three months ended March 31, 2016 compared to RUB 45,749 million for the same period of the prior year. This change is mainly related to an increase in volumes of oil purchased on domestic market.

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Three months ended	
	March 31,	
	2016	2015
Mineral extraction tax	153,800	180,798
Property tax	32,656	29,868
Other taxes	<u>31,202</u>	<u>23,473</u>
Taxes other than on income	217,658	234,139

Mineral extraction tax decreased by 15 % to RUB 153,800 million for the three months ended March 31, 2016 compared to RUB 180,798 million for the same period of the prior year. This change was due to a decrease of oil prices.

Staff costs

Staff costs increased by 17 % to RUB 170,085 million for the three months ended March 31, 2016 compared to RUB 145,097 million for the same period of the prior year. The increase was mainly driven by average salary growth.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 33 % to RUB 165,910 million for the three months ended March 31, 2016 compared to RUB 124,604 million for the same period of the prior year. This increase was mainly driven by an increase in cost of transit of gas through the territory of Ukraine denominated in Ruble terms and the activity of the GAZPROM Germania Group.

Depreciation

Depreciation increased by RUB 17,677 million, or 14 %, to RUB 141,948 million for the three months ended March 31, 2016 compared to RUB 124,271 million for the same period of the prior year. The increase was primarily due to the growth in the fixed assets base.

Charge for impairment and other provisions, net

Charge for impairment and other provisions, net increased by RUB 18,436 million or 62 % for the three months ended March 31, 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.

Foreign exchange rate differences on operating items

Foreign exchange rate differences on operating items increased by RUB 25,211 million and amounted to a net loss of RUB 42,655 million for the three months ended March 31, 2016 compared to a net loss of RUB 17,444 million for the same period of the prior year. This change was explained by the depreciation of US Dollar against the Russian Rouble by 7 % and the depreciation of Euro against the Russian Rouble by 4 % for the three months ended March 31, 2016 compared to the appreciation of US Dollar against the Russian Rouble by 4 % and the depreciation of Euro against the Russian Rouble by 7 % for the same period of the prior year.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products, decreased from RUB 41,839 million for the three months ended March 31, 2015 to RUB 31,415 million for the three months ended March 31, 2016. The decrease was mainly explained by a decrease in volumes of refined products purchased and a decrease in oil and oil products prices.

Other operating expenses

Other operating expenses decreased by 30 % to RUB 62,874 million for the three months ended March 31, 2016 compared to RUB 90,333 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 63,377 million to RUB 90,948 million for the three months ended March 31, 2016 compared to RUB 27,571 million for the same period of the prior year. The change in this line item is explained by the fact that a decrease in the balances of finished goods as of March 31, 2016 was more than a decrease 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 156,682 million, or 34 %, to RUB 301,973 million for the three months ended March 31, 2016 from RUB 458,655 million for the same period of the prior year. The operating profit margin decreased from 28 % for the three months ended March 31, 2015 to 17 % for the three months ended March 31, 2016.

Net finance income

(RUB million)	Three months ended	
	March 31,	
	2016	2015
Exchange gains	377,559	654,715
Exchange losses	(215,192)	(669,808)
Net exchange gain (loss)	162,367	(15,093)
Interest income	25,780	28,960
Interest expense	(21,360)	(13,780)
Net finance income	166,787	87

The net exchange gain in the amount of RUB 162,367 million for the three months ended March 31, 2016 compared to the net exchange loss in the amount of RUB 15,093 million for the same period of the prior year was mainly explained by the depreciation of US Dollar against the Russian Rouble by 7 % and the depreciation of Euro against the Russian Rouble by 4 % for the three months ended March 31, 2016 compared to the appreciation of US Dollar against the Russian Rouble by 4 % and the depreciation of Euro against the Russian Rouble by 7 % for the same period of the prior year.

Interest income decreased by 11 % to RUB 25,780 million for the three months ended March 31, 2016 from RUB 28,960 million for the same period of the prior year.

Interest expense increased by 55 % to RUB 21,360 million for the three months ended March 31, 2016 compared to RUB 13,780 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 24,469 million to RUB 12,845 million for the three months ended March 31, 2016 compared to RUB 37,314 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 31,137 million that was partially offset by the increase in the share of net income of Gazprombank (Joint Stock Company) and its subsidiaries by RUB 7,181 million.

Profit tax

Total profit tax expense increased by RUB 2,143 million, or 2 %, to RUB 108,619 million for the three months ended March 31, 2016 compared to RUB 106,476 million for the same period of the prior year. The effective profit tax rate was 22.5 % and 21.5 % for the three months ended March 31, 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 for the three months ended March 31, 2016 compared for the same period of the prior year.

Profit for the period attributable to owners of PJSC Gazprom

As a result of the factors discussed above, profit for the period attributable to owners of PJSC Gazprom decreased by RUB 19,803 million, or 5 %, from RUB 382,112 million for the three months ended March 31, 2015 to RUB 362,309 million for the three months ended March 31, 2016.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 3,526 million, or 47 %, to RUB 11,032 million for the three months ended March 31, 2016 compared to RUB 7,506 million for the same period of the prior year.

Liquidity and capital resources

The following table summarises the cash flows for the three months ended March 31, 2016 and 2015:

(RUB million)	Three months ended March 31,	
	2016	2015
Net cash from operating activities	674,327	696,196
Net cash used in investing activities	(474,995)	(487,594)
Net cash from (used in) financing activities	68,596	(26,230)

Net cash from operating activities

Net cash from operating activities decreased by RUB 21,869 million, or 3 %, to RUB 674,327 million for the three months ended March 31, 2016 compared to RUB 696,196 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 12,599 million, or 3 %, to RUB 474,995 million for the three months ended March 31, 2016 compared to RUB 487,594 million for the same period of the prior year. The change was primarily due to proceeds from the sale of associates for the three months ended March 31, 2016.

Net cash from (used in) financing activities

Net cash from financing activities increased by RUB 94,826 million to RUB 68,596 million for the three months ended March 31, 2016 compared to net cash used in financing activities in the amount of RUB 26,230 million for the same period of the prior year. This change was primarily due to excess of proceeds from borrowings over cash used for repayment of borrowings for the three months ended March 31, 2016.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the three months ended March 31, 2016 and 2015 in RUB terms, amounted to the following:

(RUB million)	Three months ended March 31,	
	2016 ⁽¹⁾	2015 ⁽¹⁾
Transportation	141,180	88,940
Production of crude oil and gas condensate	87,716	67,243
Production of gas	33,699	33,695
Refining	28,875	30,858
Electric and heat energy generation and sales	12,167	14,351
Gas storage	4,628	3,176
Distribution of gaz	2,700	4,151
All other segments	13,434	9,678
Total	324,399	252,092

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 of PJSC Gazprom primarily due to VAT.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RUB 72,307 million, or 29 %, from RUB 252,092 million for the three months ended March 31, 2015 to RUB 324,399 million for the three months ended March 31, 2016.

Debts

Net debt balance (defined as the sum of short-term borrowings, current portion of long-term borrowings, short-term promissory notes payable, long-term borrowings, long-term promissory notes payable, net of cash and cash equivalents and balances of cash and cash equivalents restricted as to withdrawal under the terms of certain borrowings and other contractual obligations) decreased by RUB 300,102 million, or 14 %, from RUB 2,083,120 million as of December 31, 2015 to RUB 1,783,018 million as of March 31, 2016. This decrease was resulted from an increase in cash and cash equivalents and a change in foreign currency exchange rates (depreciation of US Dollar and Euro).