

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 six months ended June 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 six months ended June 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 June 30, 2017 – 59.0855 (as of June 30, 2016 – 64.2575);
- 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 June 30, 2017 – 67.4993 (as of June 30, 2016 – 71.2102);
- as of December 31, 2016 – 63.8111 (as of December 31, 2015 – 79.6972).

The average exchange rates of Russian Ruble for the six months ended 30 June, 2017 and for the six months ended 30 June, 2016 were:

- to US Dollar – 57.9862 and 70.2583, respectively;
- to Euro – 62.7187 and 78.3669, respectively.

RESULTS OF OPERATION

(RUB million)	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Sales	1,394,633	1,327,008	3,209,934	3,064,372
Net (loss) gain from trading activity	(6,124)	11,021	(20,327)	29,529
Operating expenses	<u>(1,198,211)</u>	<u>(1,226,833)</u>	<u>(2,705,306)</u>	<u>(2,680,732)</u>
Operating profit	190,298	111,196	484,301	413,169
Finance income	52,912	296,929	236,044	700,268
Finance expense	(186,939)	(130,835)	(239,627)	(367,387)
Share of net income of associates and joint ventures	26,414	20,921	55,969	33,766
Gain on disposal of available-for-sale financial assets	<u>4</u>	<u>666</u>	<u>50</u>	<u>1,021</u>
Profit before profit tax	82,689	298,877	536,737	780,837
Current profit tax expense	(16,082)	(34,271)	(83,162)	(105,785)
Deferred profit tax expense	<u>(8,940)</u>	<u>(12,542)</u>	<u>(45,521)</u>	<u>(49,647)</u>
Profit tax	(25,022)	(46,813)	(128,683)	(155,432)
Profit for the period	57,667	252,064	408,054	625,405
Other comprehensive income (loss):				
Items that will not be reclassified to profit or loss:				
Remeasurements of post-employment benefit obligations	<u>22,334</u>	<u>(47,844)</u>	<u>(14,236)</u>	<u>(78,625)</u>
Total items that will not be reclassified to profit or loss	22,334	(47,844)	(14,236)	(78,625)
Items that may be reclassified subsequently to profit or loss:				
(Loss) gain arising from change in fair value of available-for-sale financial assets, net of tax	(13,420)	16,415	(40,227)	20,806
Share of other comprehensive income (loss) of associates and joint ventures	1,678	(961)	2,125	(4,518)
Translation differences	104,785	(88,542)	23,113	(186,490)
(Loss) gain from cash flow hedges, net of tax	<u>(2,209)</u>	<u>12,760</u>	<u>(4,423)</u>	<u>39,535</u>
Total items that may be reclassified subsequently to profit or loss	90,834	(60,328)	(19,412)	(130,667)
Other comprehensive income (loss) for the period, net of tax	113,168	(108,172)	(33,648)	(209,292)
Total comprehensive income for the period	170,835	143,892	374,406	416,113
Profit for the period attributable to:				
Owners of PJSC Gazprom	47,893	244,851	381,346	607,160
Non-controlling interest	<u>9,774</u>	<u>7,213</u>	<u>26,708</u>	<u>18,245</u>
	57,667	252,064	408,054	625,405
Total comprehensive income for the period attributable to:				
Owners of PJSC Gazprom	151,861	140,355	343,027	405,536
Non-controlling interest	<u>18,974</u>	<u>3,537</u>	<u>31,379</u>	<u>10,577</u>
	170,835	143,892	374,406	416,113

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Sales of gas				
<i>Europe and Other countries</i>				
Gross sales ⁽¹⁾	587,005	583,982	1,323,605	1,399,940
Customs duties	(116,740)	(111,160)	(247,025)	(251,189)
Excise tax	(10,355)	(7,727)	(22,791)	(20,480)
Net sales	459,910	465,095	1,053,789	1,128,271
Volumes in bcm	53.5	51.3	119.1	109.4
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	192.4	172.6	192.1	182.2
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	10,983.3	11,382.1	11,117.2	12,798.3
<i>Former Soviet Union countries</i>				
Gross sales ⁽¹⁾	53,509	54,205	167,194	182,139
Customs duties	(4,376)	(4,519)	(15,926)	(15,518)
Net sales	49,133	49,686	151,268	166,621
Volumes in bcm	5.9	5.5	18.4	16.4
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	160.2	150.6	157.4	158.6
Average price, RUB per mcm ⁽²⁾ (including customs duties)	9,145.3	9,927.6	9,107.4	11,135.9
<i>Russian Federation</i>				
Gross sales (net of VAT)	154,270	128,545	466,525	420,395
Net sales	154,270	128,545	466,525	420,395
Volumes in bcm	42.4	34.3	124.1	109.7
Average price, RUB per mcm ⁽²⁾ (net of VAT)	3,646.3	3,738.9	3,760.7	3,831.0
<i>Total sales of gas</i>				
Gross sales (net of VAT)	794,784	766,732	1,957,324	2,002,474
Customs duties	(121,116)	(115,679)	(262,951)	(266,707)
Excise tax	(10,355)	(7,727)	(22,791)	(20,480)
Retroactive gas price adjustments	(7,055)	39,091	(7,304)	39,984
Net sales	656,258	682,417	1,664,278	1,755,271
Volumes in bcm	101.8	91.1	261.6	235.5
Net sales of refined products (net of excise tax, VAT and customs duties)	387,149	365,528	780,812	703,468
Net sales of crude oil and gas condensate (net of VAT and customs duties)	134,461	91,020	273,298	166,549
Electric and heat energy net sales (net of VAT)	103,165	88,722	263,155	236,292
Gas transportation net sales (net of VAT)	58,895	48,176	117,482	95,772
Other revenues (net of VAT)	<u>54,705</u>	<u>51,145</u>	<u>110,909</u>	<u>107,020</u>
Total sales (net of excise tax, VAT and customs duties)	1,394,633	1,327,008	3,209,934	3,064,372

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 145,562 million, or 5 %, to RUB 3,209,934 million for the six months ended June 30, 2017 compared to the same period of the prior year. The increase in sales was mainly driven by an increase in sales of crude oil and refined products and electric and heat energy.

Net sales of gas for the six months ended June 30, 2017 was 52 % of total net sales (57 % for the same period of the prior year).

Net sales of gas decreased by RUB 90,993 million, or 5 %, from RUB 1,755,271 million for the six months ended June 30, 2016 to RUB 1,664,278 million for the six months ended June 30, 2017.

Net sales of gas to Europe and Other countries decreased by RUB 74,482 million, or 7 %, to RUB 1,053,789 million for the six months ended June 30, 2017 compared to the same period of the prior year. The decrease in sales of gas to Europe and Other countries was driven by the 13 % decrease in average Russian Ruble prices (including excise tax and customs duties) that was partially compensated by the increase in volumes of gas sold by 9 % for the six months ended June 30, 2017 compared to the same period of the prior year. At the same time the average US Dollar prices increased by 5 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries decreased by RUB 15,353 million, or 9 %, to RUB 151,268 million for the six months ended June 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 18 % that was partially compensated by the increase in volumes of gas sold by 12 % for the six months ended June 30, 2017.

Net sales of gas in the Russian Federation increased by RUB 46,130 million, or 11 %, to RUB 466,525 million for the six months ended June 30, 2017 compared to the same period of the prior year. This change is mainly explained by the 13 % increase in volumes of gas sold that was partially compensated by the decrease in average Russian Ruble prices (net of VAT) by 2 %.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 77,344 million, or 11 %, to RUB 780,812 million for the six months ended June 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 106,749 million, or 64 %, to RUB 273,298 million for the six months ended June 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, Prirazlomnoye and Messoyakha fields, decreased supplies to the refinery and increased production in Iraq and also due to an increase in average prices in all geographic segments.

Electric and heat energy net sales (net of VAT) increased by RUB 26,863 million, or 11 %, to RUB 263,155 million for the six months ended June 30, 2017 compared to the same period of the prior year. The increase of electric and heat energy sales was due to an increase in volumes of heat energy and capacity as well as due to a longer heating period.

Operating expenses

Operating expenses increased by 1 % for the six months ended June 30, 2017 to RUB 2,705,306 million in comparison with RUB 2,680,732 million for the same period of the prior year. Operating expenses as a percentage of sales decreased from 87 % for the six months ended June 30, 2016 to 84 % for the six months ended June 30, 2017. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Three months ended June, 30		Six months ended June, 30	
	2017	2016	2017	2016
Taxes other than on income	271,152	211,835	566,177	429,493
Purchased gas and oil	248,695	281,318	565,600	627,258
Staff costs	171,393	163,791	341,074	333,876
Depreciation	153,609	140,167	303,303	282,115
Transit of gas, oil and refined products	140,818	137,880	287,831	303,790
Materials	64,918	69,846	124,513	129,477
Cost of goods for resale, including refined products	55,835	44,674	112,839	76,089
Repairs and maintenance	35,776	42,317	59,183	61,828
Charge for impairment and other provisions	18,834	15,275	54,204	63,424
Electricity and heating expenses	22,954	21,375	53,084	44,954
Rental expenses	10,218	9,142	20,880	18,023
Transportation services	7,930	8,620	15,736	15,808
Social expenses	8,620	7,972	15,220	14,418
Insurance expenses	7,167	7,443	14,532	14,699
Processing services	3,895	3,496	7,451	7,821
Research and development expenses	109	5,801	6,207	13,076
Foreign exchange rate differences on operating items	(9,647)	20,664	(8,760)	63,319
Derivatives loss (gain)	2,670	17,978	(7,351)	10,203
Other	68,287	87,433	177,882	150,307
	1,283,233	1,297,027	2,709,605	2,659,978
Changes in inventories of finished goods, work in progress and other effects	<u>(85,022)</u>	<u>(70,194)</u>	<u>(4,299)</u>	<u>20,754</u>
Total operating expenses	1,198,211	1,226,833	2,705,306	2,680,732

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Mineral extraction tax	188,518	136,777	406,549	290,577
Property tax	36,093	31,629	76,008	64,285
Excise tax	39,558	37,244	74,591	65,936
Other taxes	6,983	6,185	9,029	8,695
Taxes other than on income	271,152	211,835	566,177	429,493

Mineral extraction tax increased by RUB 115,972 million, or 40 %, to RUB 406,549 million for the six months ended June 30, 2017 compared to RUB 290,557 million for the same period of the prior year.

Property tax increased by RUB 11,723 million, or 18 %, to RUB 76,008 million for the six months ended June 30, 2017 compared to RUB 64,285 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 61,658 million, or 10 %, to RUB 565,600 million for the six months ended June 30, 2017 compared to RUB 627,258 million for the same period of the prior year.

Cost of purchased gas decreased by RUB 89,644 million, or 18 %, to RUB 409,842 million for the six months ended June 30, 2017 compared to RUB 499,486 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 27,986 million, or 22 %, to RUB 155,758 million for the six months ended June 30, 2017 compared to RUB 127,772 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 15,959 million, or 5 %, to RUB 287,831 million for the six months ended June 30, 2017 compared to RUB 303,790 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 36,750 million, or 48 %, to RUB 112,839 million for the six months ended June 30, 2017 compared to RUB 76,089 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 9,220 million, or 15 %, to RUB 54,204 million for the six months ended June 30, 2017 compared to RUB 63,424 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 and charge for impairment allowance for doubtful prepayments for the six months ended June 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 8,760 million for the six months ended June 30, 2017 compared to a foreign exchange rate loss of RUB 63,319 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 3 % and by the appreciation of Euro against the Russian Ruble by 6 % for the six months ended June 30, 2017 compared to a depreciation of US Dollar and Euro against the Russian Ruble by 12 % 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 71,132 million, or 17 %, to RUB 484,301 million for the six months ended June 30, 2017 from RUB 413,169 million for the same period of the prior year. The operating profit margin increased from 13 % for the six months ended June 30, 2016 to 15 % for the six months ended June 30, 2017.

Net finance (expense) income

(RUB million)	Three months ended June 30,		Six months ended June 30,	
	2017	2016	2017	2016
Foreign exchange gain	30,595	268,073	191,381	645,632
Foreign exchange loss	<u>(171,103)</u>	<u>(116,086)</u>	<u>(208,684)</u>	<u>(331,278)</u>
Net foreign exchange (loss) gain	(140,508)	151,987	(17,303)	314,354
Interest income	22,317	28,856	44,663	54,636
Interest expense	<u>(15,836)</u>	<u>(14,749)</u>	<u>(30,943)</u>	<u>(36,109)</u>
Net finance (expense) income	(134,027)	166,094	(3,583)	332,881

The net foreign exchange loss of RUB 17,303 million and the net foreign exchange gain of RUB 314,354 million for the six months ended June 30, 2017 and 2016, respectively, was mainly explained by the depreciation of US Dollar against the Russian Ruble by 3 % and by the appreciation of Euro against the Russian Ruble by 6 % for the six months ended June 30, 2017 compared to a depreciation of US Dollar and Euro against the Russian Ruble by 12 % and 11 %, respectively, for the same period of the prior year.

Interest income decreased by RUB 9,973 million, or 18 %, to RUB 44,663 million for the six months ended June 30, 2017 from RUB 54,636 million for the same period of the prior year.

Interest expense decreased by RUB 5,166 million, or 14 %, to RUB 30,943 million for the six months ended June 30, 2017 compared to RUB 36,109 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 22,203 million, or 66 %, to RUB 55,969 million for the six months ended June 30, 2017 compared to RUB 33,766 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 26,749 million, or 17 %, to RUB 128,683 million for the six months ended June 30, 2017 compared to RUB 155,432 million for the same period of the prior year. The effective profit tax rate was 24.0 % and 19.9 % for the six months ended June 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 225,814 million, or 37 %, from RUB 607,160 million for the six months ended June 30, 2016 to RUB 381,346 million for the six months ended June 30, 2017.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 8,463 million, or 46 %, to RUB 26,708 million for the six months ended June 30, 2017 compared to RUB 18,245 million for the same period of the prior year.

Liquidity and capital resources

The following table summarises the cash flows for the six months ended June 30, 2017 and 2016:

(RUB million)	Six months ended	
	June 30,	
	2017	2016
Net cash from operating activities	446,577	931,592
Net cash used in investing activities	(749,019)	(822,608)
Net cash from (used in) financing activities	179,087	(44,131)

Net cash from operating activities

Net cash from operating activities decreased by RUB 485,015 million, or 52 %, to RUB 446,577 million for the six months ended June 30, 2017 compared to RUB 931,592 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 73,589 million, or 9 %, to RUB 749,019 million for the six months ended June 30, 2017 compared to RUB 822,608 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 179,087 million for the six months ended June 30, 2017 compared to net cash used in financing activities of RUB 44,131 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 six months ended June 30, 2017 and 2016 in Russian Ruble terms amounted to the following:

(RUB million)	Six months ended June 30,	
	2017	2016
Transportation	173,888	162,619
Production of crude oil and gas condensate	171,080	143,650
Refining	96,770	51,212
Production of gas	52,464	64,445
Electric and heat energy generation and sales	15,536	28,011
Distribution of gas	11,766	6,653
Gas storage	6,611	15,228
All other segments	<u>11,472</u>	<u>22,141</u>
Total	<u>539,587</u>	<u>493,959</u>

Total capital expenditures increased by RUB 45,628 million, or 9 %, from RUB 493,959 million for the six months ended June 30, 2016 to RUB 539,587 million for the six months ended June 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 359,211 million, or 19 %, from RUB 1,932,895 million as of December 31, 2016 to RUB 2,292,106 million as of June 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 short-term deposits in the amount of RUB 359,418 million for the six months ended 30 June, 2017.