

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, 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 three months ended March 31, 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 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,	
	2017	2016
Sales	1,815,301	1,737,364
Net (loss) gain from trading activity	(14,203)	18,508
Operating expenses	<u>(1,507,095)</u>	<u>(1,453,899)</u>
Operating profit	294,003	301,973
Finance income	183,132	403,339
Finance expense	(52,688)	(236,552)
Share of net income of associates and joint ventures	29,555	12,845
Gain on disposal of available-for-sale financial assets	<u>46</u>	<u>355</u>
Profit before profit tax	454,048	481,960
Current profit tax expense	(67,080)	(71,514)
Deferred profit tax expense	<u>(36,581)</u>	<u>(37,105)</u>
Profit tax	(103,661)	(108,619)
Profit for the period	350,387	373,341
Other comprehensive income (loss):		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(36,570)</u>	<u>(30,781)</u>
Total items that will not be reclassified to profit or loss	(36,570)	(30,781)
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	(26,807)	4,391
Share of other comprehensive income (loss) of associates and joint ventures	447	(3,557)
Translation differences	(81,672)	(97,948)
(Loss) gain from cash flow hedges, net of tax	<u>(2,214)</u>	<u>26,775</u>
Total items that may be reclassified subsequently to profit or loss	(110,246)	(70,339)
Other comprehensive loss for the period, net of tax	(146,816)	(101,120)
Total comprehensive income for the period	203,571	272,221
Profit for the period attributable to:		
Owners of PJSC Gazprom	333,453	362,309
Non-controlling interest	<u>16,934</u>	<u>11,032</u>
	350,387	373,341
Total comprehensive income for the period attributable to:		
Owners of PJSC Gazprom	191,166	265,181
Non-controlling interest	<u>12,405</u>	<u>7,040</u>
	203,571	272,221

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Three months ended	
	March 31,	
	2017	2016
Sales of gas		
<i>Europe and Other countries</i>		
Gross sales ⁽¹⁾	736,600	815,958
Customs duties	(130,285)	(140,029)
Excise tax	(12,436)	(12,753)
Net sales	593,879	663,176
Volumes in bcm	65.6	58.1
Average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	191.3	187.5
Average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	11,226.3	14,049.3
<i>Former Soviet Union countries</i>		
Gross sales ⁽¹⁾	113,685	127,934
Customs duties	(11,550)	(10,999)
Net sales	102,135	116,935
Volumes in bcm	12.5	10.9
Average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	154.9	156.7
Average price, RUB per mcm ⁽²⁾ (including customs duties)	9,089.7	11,741.3
<i>Russian Federation</i>		
Gross sales (net of VAT)	312,255	291,850
Net sales	312,255	291,850
Volumes in bcm	81.7	75.4
Average price, RUB per mcm ⁽²⁾ (net of VAT)	3,819.9	3,872.9
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,162,540	1,235,742
Customs duties	(141,835)	(151,028)
Excise tax	(12,436)	(12,753)
Retroactive gas price adjustments	(249)	893
Net sales	1,008,020	1,072,854
Volumes in bcm	159.8	144.4
Net sales of refined products (net of excise tax, VAT and customs duties)	393,663	337,940
Electric and heat energy net sales (net of VAT)	159,990	147,570
Net sales of crude oil and gas condensate (net of VAT and customs duties)	138,837	75,529
Gas transportation net sales (net of VAT)	58,587	47,596
Other revenues (net of VAT)	<u>56,204</u>	<u>55,875</u>
Total sales (net of excise tax, VAT and customs duties)	<u>1,815,301</u>	<u>1,737,364</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 77,937 million, or 4 %, to RUB 1,815,301 million for the three months ended March 31, 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 gas condensate and refined products that was partially compensated by a decrease in sales of gas to Europe and other countries and Former Soviet Union countries.

Net sales of gas for the three months ended March 31, 2017 was 56 % of total net sales (62 % for the same period of the prior year).

Net sales of gas decreased by RUB 64,834 million, or 6 %, from RUB 1,072,854 million for the three months ended March 31, 2016 to RUB 1,008,020 million for the three months ended March 31, 2017.

Net sales of gas to Europe and Other countries decreased by RUB 69,297 million, or 10 %, to RUB 593,879 million for the three months ended March 31, 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 20 % decrease in average Russian Ruble prices (including excise tax and customs duties) for the three months ended March 31, 2017 compared to the same period of the prior year. At the same time the volumes of gas sold increased by 13 % compared to the same period of the prior year.

Net sales of gas to Former Soviet Union countries decreased by RUB 14,800 million, or 13 %, to RUB 102,135 million for the three months ended March 31, 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 23 % that was partially compensated by the increase in volumes of gas sold by 15 % for the three months ended March 31, 2017.

Net sales of gas in the Russian Federation increased by RUB 20,405 million, or 7 %, to RUB 312,255 million for the three months ended March 31, 2017 compared to the same period of the prior year. This is mainly explained by the 8 % 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 55,723 million, or 16 %, to RUB 393,663 million for the three months ended March 31, 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 63,308 million, or 84 %, to RUB 138,837 million for the three months ended March 31, 2017 compared to the same period of the prior year. The increase in sales of crude oil was due to an increase in average prices in all geographic segments and also due to an increase in volumes of crude oil sold by Gazprom Neft Group to customers in Europe and Other countries.

Operating expenses

Operating expenses increased by 4 % for the three months ended March 31, 2017 to RUB 1,507,095 million in comparison with RUB 1,453,899 million for the same period of the prior year. Operating expenses as a percentage of sales decreased from 84 % for the three months ended March 31, 2016 to 83 % for the three months ended March 31, 2017. The table below presents a breakdown of operating expenses in each period:

	Three months ended 31 March	
	2017	2016
Purchased gas and oil	316,905	345,940
Taxes other than on income	295,025	217,658
Staff costs	169,681	170,085
Depreciation	149,694	141,948
Transit of gas, oil and refined products	147,013	165,910
Materials	59,595	59,631
Cost of goods for resale, including refined products	57,004	31,415
Charge for impairment and other provisions	35,370	48,149
Electricity and heating expenses	30,130	23,579
Repairs and maintenance	23,407	19,511
Rental expenses	10,662	8,881
Transportation services	7,806	7,188
Research and development expenses	7,398	7,275
Insurance expenses	7,365	7,256
Social expenses	6,600	6,446
Processing services	3,556	4,325
Foreign exchange rate differences on operating items	887	42,655
Derivatives gains	(10,021)	(7,775)
Other	108,295	62,874
	<u>1,426,372</u>	<u>1,362,951</u>
Changes in inventories of finished goods, work in progress and other effects	80,723	90,948
Total operating expenses	<u>1,507,095</u>	<u>1,453,899</u>

Purchased gas and oil

Cost of purchased gas and oil decreased by RUB 29,035 million, or 8 %, to RUB 316,905 million for the three months ended March 31, 2017 compared to RUB 345,940 million for the same period of the prior year.

Cost of purchased gas decreased by RUB 50,872 million, or 17 %, to RUB 240,707 million for the three months ended March 31, 2017 compared to RUB 291,579 million for the same period of the prior year. This increase was mainly due to a decrease in purchases of gas of GAZPROM Germania Group in Russian Ruble terms.

Cost of purchased oil included in the purchased gas and oil increased by RUB 21,837 million, or 40 %, to RUB 76,198 million for the three months ended March 31, 2017 compared to RUB 54,361 million for the same period of the prior year. This change was mainly related to an increase in prices of oil and an increase in demand for oil in Europe and Other countries.

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Three months ended 31 March	
	2017	2016
Mineral extraction tax	218,031	153,800
Property tax	39,915	32,656
Excise tax	35,033	28,692
Other taxes	2,046	2,510
Taxes other than on income	295,025	217,658

Mineral extraction tax increased by 42 % to RUB 218,031 million for the three months ended March 31, 2017 compared to RUB 153,800 million for the same period of the prior year.

Depreciation

Depreciation increased by RUB 7,746 million, or 5 %, to RUB 149,694 million for the three months ended March 31, 2017 compared to RUB 141,948 million for the same period of the prior year. The increase was mainly due to the growth in the fixed assets base.

Transit of gas, oil and refined products

Transit of gas, oil and refined products decreased by RUB 18,897 million, or 11 % to RUB 147,013 million for the three months ended March 31, 2017 compared to RUB 165,910 million for the same period of the prior year. This decrease was mainly driven by the depreciation of US Dollar and Euro against the Russian Ruble.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products, increased by RUB 25,589 million, or 81 %, to RUB 57,004 million for the three months ended March 31, 2017 compared to RUB 31,415 million for the same period of the prior year. The increase was mainly due to increased volume 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 decreased by RUB 12,779 million, or 27 %, to RUB 35,370 million for the three months ended March 31, 2017 compared to RUB 48,149 million for the prior year. The change was mainly driven by a decrease in charges for impairment allowance for doubtful accounts receivable for NJSC Naftogaz Ukraine and JSC Moldovagaz for the three months ended March 31, 2017 compared to the charges for impairment allowance for doubtful accounts receivable for the same period of the prior year.

Foreign exchange rate differences on operating items

Foreign exchange rate loss on operating items decreased by RUB 41,768 million and amounted to RUB 887 million for the three months ended March 31, 2017 compared to a loss of RUB 42,655 million for the same period of the prior year. This change was mainly due to a decrease in foreign exchange rate losses of forward contracts and the depreciation of US Dollar and Euro against the Russian Ruble.

Other operating expenses

Other operating expenses increased by RUB 45,421 million, or 72 % to RUB 108,295 million for the three months ended March 31, 2017 compared to RUB 62,874 million for the same period of the prior year mainly due to an increase in charity expenses. Other operating 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 decreased by RUB 10,225 million to RUB 80,723 million for the three months ended March 31, 2017 compared to RUB 90,948 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

for the three months ended March 31, 2017 was less 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 7,970 million, or 3 %, to RUB 294,003 million for the three months ended March 31, 2017 from RUB 301,973 million for the same period of the prior year. The operating profit margin decreased from 17 % for the three months ended March 31, 2016 to 16 % for the three months ended March 31, 2017.

Net finance income

(RUB million)	Three months ended 31 March	
	2017	2016
Foreign exchange gain	160,786	377,559
Foreign exchange loss	(37,581)	(215,192)
Net foreign exchange gain	123,205	162 367
Interest income	22,346	25 780
Interest expense	(15,107)	(21 360)
Net finance income	130,444	166 787

The net foreign exchange gain of RUB 123,205 million and RUB 162,367 million for the three months ended March 31, 2017 and 2016, respectively, was mainly explained by the depreciation of US Dollar and Euro against the Russian Ruble by 7 % and 5 %, respectively, for the three months ended March 31, 2017 compared to a depreciation of US Dollar and Euro against the Russian Ruble by 7 % and 4 %, respectively, for the same period of the prior year. A decrease in the net foreign exchange gain by RUB 39,162 million, or 24 %, for the three months ended March 31, 2017 compared to the same period of the prior year was mainly explained by a decrease in cash and borrowings in US Dollar.

Interest income decreased by 13 % to RUB 22,346 million for the three months ended March 31, 2017 from RUB 25,780 million for the same period of the prior year.

Interest expense decreased by 29 % to RUB 15,107 million for the three months ended March 31, 2017 compared to RUB 21,360 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 16,710 million to RUB 29,555 million for the three months ended March 31, 2017 compared to RUB 12,845 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 4,958 million, or 5 %, to RUB 103,661 million for the three months ended March 31, 2017 compared to RUB 108,619 million for the same period of the prior year. The effective profit tax rate was 22.8 % and 22.5 % for the three months ended March 31, 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 28,856 million, or 8 %, from RUB 362,309 million for the three months ended March 31, 2016 to RUB 333,453 million for the three months ended March 31, 2017.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 5,902 million, or 53 %, to RUB 16,934 million for the three months ended March 31, 2017 compared to RUB 11,032 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, 2017 and 2016:

(RUB million)	Three months ended 31 March	
	2017	2016
Net cash from operating activities	105,402	674,327
Net cash used in investing activities	(327,038)	(474,995)
Net cash from financing activities	34,503	68,596

Net cash from operating activities

Net cash from operating activities decreased by RUB 568,925 million, or 84 %, to RUB 105,402 million for the three months ended March 31, 2017 compared to RUB 674,327 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 147,957 million, or 31 %, to RUB 327,038 million for the three months ended March 31, 2017 compared to RUB 474,995 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, as well as to an increase in interest received for the three months ended March 31, 2017. 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 financing activities

Net cash used in financing activities decreased by RUB 34,093 million, or 50 %, to RUB 34,503 million for the three months ended March 31, 2017 compared to RUB 68,596 million for the same period of the prior year. This change was mainly due to a decrease in proceeds from borrowings including the effect of the depreciation of US Dollar and Euro against the Russian Ruble.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segments for the three months ended March 31, 2017 and 2016 in RUB terms, amounted to the following:

(RUB million)	Three months ended 31 March	
	2017	2016
Production of crude oil and gas condensate	83,242	77,283
Transportation	59,210	111,077
Refining	37,056	25,154
Production of gas	27,153	20,705
Electric and heat energy generation and sales	7,665	10,748
Distribution of gas	5,539	2,552
Gas storage	2,547	3,892
All other segments	4,057	10,843
Total	226,469	262,254

Total capital expenditures decreased by RUB 35,785 million, or 14 %, from RUB 262,254 million for the three months ended March 31, 2016 to RUB 226,469 million for the three months ended March 31, 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 110,418 million, or 6 %, from

RUB 1,932,895 million as of December 31, 2016 to RUB 2,043,313 million as of March 31, 2017. This increase was mainly due to a decrease in cash and cash equivalents.