

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 six months ended June 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)

	Six months periods ended June 30,	
	2012	2011
Sales	2,230,366	2,347,071
Net gain (loss) from trading activity	5,518	(236)
Operating expenses	<u>(1,623,751)</u>	<u>(1,498,340)</u>
Operating profit	612,133	848,495
Finance income	153,393	106,765
Finance expense	(182,063)	(44,675)
Share of net income of associated undertakings and jointly controlled entities	71,689	62,566
(Losses) gains on disposal of available-for-sale financial assets	<u>(78)</u>	<u>831</u>
Profit before profit tax	655,074	973,982
Current profit tax expense	(139,132)	(170,346)
Deferred profit tax benefit (expense)	<u>9,584</u>	<u>(18,434)</u>
Profit tax expense	(129,548)	(188,780)
Profit for the period	525,526	785,202
Other comprehensive income		
Losses arising from change in fair value of available-for-sale financial assets, net of tax	(22,019)	(2,389)
Share of other comprehensive loss of associated undertakings and jointly controlled entities	(5,039)	(6,352)
Translation differences	8,037	(25,034)
Losses from cash flow hedges, net of tax	<u>(6,040)</u>	<u>-</u>
Other comprehensive loss for the period, net of tax	(25,061)	(33,775)
Total comprehensive income for the period	500,465	751,427
Profit attributable to:		
owners of OAO Gazprom	508,667	771,669
non-controlling interest	<u>16,859</u>	<u>13,533</u>
	525,526	785,202
Total comprehensive income attributable to:		
owners of OAO Gazprom	482,933	739,777
non-controlling interest	<u>17,532</u>	<u>11,650</u>
	500,465	751,427

Sales

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

(RUB million unless indicated otherwise)	Six months periods ended June 30,	
	2012	2011
Sales of gas		
<i>Europe and other countries</i>		
Gross sales ⁽¹⁾	907,987	896,354
Customs duties	(176,671)	(154,142)
Net sales	731,316	742,212
Volumes in billion cubic meters (bcm)	77.9	86.6
Gross average price, U.S.\$ per mcm ⁽²⁾ (including customs duties) ⁽³⁾	381.2	361.8
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	11,657.9	10,356.0
<i>FSU (Former Soviet Union)</i>		
Gross sales (net of value added tax (VAT))	304,283	357,470
Customs duties	(47,588)	(26,036)
Net sales	256,695	331,434
Volumes in bcm	33.3	46.8
Gross average price, U.S.\$ per mcm ⁽²⁾ (including customs duties, net of VAT) ⁽³⁾	298.8	266.6
Gross average price, RUB per mcm ⁽²⁾ (including customs duties, net of VAT)	9,137.9	7,630.5
<i>Russian Federation</i>		
Gross sales (net of VAT)	389,301	398,630
Net sales	389,301	398,630
Volumes in bcm	144.3	154.2
Gross average price, RUB per mcm ⁽²⁾ (net of VAT)	2,698.5	2,585.6
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,601,571	1,652,454
Customs duties	(224,259)	(180,178)
Effect of retroactive gas price adjustments	(133,186)	-
Net sales	1,244,126	1,472,276
Volumes in bcm	255.5	287.6
Net sales of refined products (net of excise tax, VAT and customs duties)	543,710	451,938
Net sales of electric and heat energy (net of VAT)	177,136	180,215
Net sales of crude oil and gas condensate (net of VAT and customs duties)	129,334	117,293
Gas transportation net sales (net of VAT)	60,279	55,500
Other revenues (net of VAT)	75,781	69,849
Total sales (net of excise tax, VAT and customs duties)	2,230,366	2,347,071

Notes:

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

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

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

Total sales (net of VAT, excise tax and customs duties) decreased by RUB 116,705 million, or 5%, to RUB 2,230,366 million in the six months period ended June 30, 2012 compared to the same period of the prior year.

Net sales of gas accounted for 56% and 63% of total net sales in the six months periods ended June 30, 2012 and 2011, respectively.

Net sales of gas decreased from RUB 1,472,276 million in the six months period ended June 30, 2011 to RUB 1,244,126 million in the six months period ended June 30, 2012, or by 15%.

Net sales of gas to Europe and other countries decreased in the six months period ended June 30, 2012 compared to the six months period ended June 30, 2011, by RUB 10,896 million, to RUB 731,316 million. The overall decrease in net sales of gas to Europe and other countries relates to decrease in volume of gas sold by 10%. The gross average RUB price (including customs duties) increased by 13% in the six months period ended June 30, 2012, compared to the six months period ended June 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 six months period ended June 30, 2012 compared to the six months period ended June 30, 2011, by RUB 74,739 million, or 23%, to RUB 256,695 million. This decrease was mainly due to the decrease in volumes of gas sold to FSU countries by 29% in the six months period ended June 30, 2012 compared to the six months period ended June 30, 2011. The gross average RUB price (including customs duties, net of VAT) increased by 20% in six months period ended June 30, 2012 compared to the same period of the prior year.

Net sales of gas in the Russian Federation decreased in the six months period ended June 30, 2012 compared to the same period of the prior year, by RUB 9,329 million, or 2%, to RUB 389,301 million. The volume of gas sold in the six months period ended June 30, 2012 decreased by 6%, compared to the six months period ended June 30, 2011. The gross average price for domestic gas sales increased by 4% in six months period ended June 30, 2012 compared to the same period of the prior year.

Net sales of refined products (net of excise tax, VAT and customs duties) increased by RUB 91,772 million, or 20%, to RUB 543,710 million in six months period ended June 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 six months period ended June 30, 2012 compared to the same period of the prior year. In the six months periods ended June 30, 2012 and 2011 Gazprom Neft Group's sales comprised 82% and 84% of the total amount of our net sales of refined products, respectively.

Net sales of electric and heat energy (net of VAT) decreased by RUB 3,079 million, or 2%, to RUB 177,136 million in the six months period ended June 30, 2012 compared to the same period of the prior year. The decrease was mainly due to the reduction of electricity prices at the day-ahead market and decrease in sales volumes of electric and heat energy.

Net sales of crude oil and gas condensate (net of VAT and customs duties) increased by RUB 12,041 million, or 10%, to RUB 129,334 million in the six months period ended June 30, 2012 compared to RUB 117,293 million in the six months period ended June 30, 2011. The increase was mainly caused by the increase in oil and gas condensate prices in the six months period ended June 30, 2012 compared to the same period of the prior year. Also the increase was supported by the increase in the volume of gas condensate sold in six months period ended June 30, 2012 compared to the same period of the prior year. Sales of crude oil amounted to RUB 104,548 million and RUB 96,232 million in the six months periods ended June 30, 2012 and 2011, respectively.

Gas transportation net sales (net of VAT) increased by RUB 4,779 million, or 9%, to RUB 60,279 million in the six months period ended June 30, 2012 from RUB 55,500 million in the six months period ended June 30, 2011. The increase was mainly caused by the increase in volume of gas transportation services rendered to independent gas suppliers in the six months period ended June 30, 2012 compared to the same period of the prior year.

Other revenues increased by RUB 5,932 million, or 8%, to RUB 75,781 million in the six months period ended June 30, 2012 compared to RUB 69,849 million in the six months period ended June 30, 2011.

Operating expenses

Operating expenses increased by 8% in the six months period ended June 30, 2012 to RUB 1,623,751 million from RUB 1,498,340 million in the six months period ended June 30, 2011. Operating expenses as a percentage of sales increased from 64% in the six months period ended June 30, 2011 to 73% in the six months period ended June 30, 2012. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Six months ended June 30,	
	2012	2011
Purchased gas and oil	411,766	452,311
Taxes other than on income	297,230	206,542
Staff costs	193,028	178,058
Transit of gas, oil and refined products	159,920	133,414
Depreciation	158,859	133,920
Repairs and maintenance	69,473	70,940
Cost of goods for resale, including refined products	60,538	50,867
Materials	57,427	49,636
Electricity and heating expenses	35,321	39,081
Charge for impairment provisions	25,845	1,350
Transportation services	17,035	16,810
Heat transmission	15,162	16,014
Losses (gains) from derivative financial instruments	14,891	(1,291)
Research and development expenses	11,647	10,193
Insurance expenses	10,980	8,339
Rental expenses	10,607	11,878
Social expenses	8,785	13,742
Processing services	6,716	4,114
Exchange rate differences on operating items	(12,823)	29,442
Other	91,732	70,142
	<u>1,644,139</u>	<u>1,495,502</u>
Changes in inventories of finished goods, work in progress and other effects	<u>(20,388)</u>	<u>2,838</u>
Total operating expenses	1,623,751	1,498,340

Purchased gas and oil

Cost of purchased gas and oil decreased by 9% to RUB 411,766 million in the six months period ended June 30, 2012 from RUB 452,311 million in the six months period ended June 30, 2011. Cost of purchased gas decreased by RUB 68,709 million, or 21%. This decrease mainly 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 28,164 million, or 22%, and amounted to RUB 153,640 million in the six months period ended June 30, 2012 in comparison with RUB 125,476 million in the six months period ended June 30, 2011 mainly due to the increase in world oil prices.

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Six months ended June 30,	
	2012	2011
Natural resources production tax	210,913	132,067
Property tax	24,678	23,264
Other taxes	61,639	51,211
Taxes other than on income	297,230	206,542

The natural resources production tax increased by 60% to RUB 210,913 million in the six months period ended June 30, 2012 from RUB 132,067 million in the six months period ended June 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 8% to RUB 193,028 million in the six months period ended June 30, 2012 from RUB 178,058 million in the six months period ended June 30, 2011. The increase mainly resulted from the salary indexation.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 20% to RUB 159,920 million in the six months period ended June 30, 2012 from RUB 133,414 million in the six months period ended June 30, 2011. This increase mainly relates to the increase in costs of transportation through Ukraine and through the "Nord Stream" pipeline.

Depreciation

Depreciation increased by 19%, or RUB 24,939 million, to RUB 158,859 million in the six months period ended June 30, 2012 from RUB 133,920 million in the six months period ended June 30, 2011. The increase relates to the growth in fixed asset base.

Repairs and maintenance

Cost of repairs and maintenance decreased by 2% to RUB 69,473 million in six months period ended June 30, 2012 from RUB 70,940 million in the six months period ended June 30, 2011. This decrease was caused by the decrease in volume of repair services rendered by third parties to the Group in the six months period ended June 30, 2012.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products increased by 19% to RUB 60,538 million in the six months period ended June 30, 2012 from RUB 50,867 million in the six months period ended June 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.

Materials

Cost of materials increased by 16% to RUB 57,427 million in the six months period ended June 30, 2012 from RUB 49,636 million in the six months period ended June 30, 2011. The increase mainly resulted from the expanding of Gazprom Group's scope of consolidation.

Electricity and heating expenses

Electricity and heating expenses decreased by 10% to RUB 35,321 million in the six months period ended June 30, 2012 from RUB 39,081 million in the six months period ended June 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 six months ended June 30, 2012 comparing to relatively stable market gas prices for the six months ended June 30, 2011.

Exchange rate differences on operating items

Exchange rate differences on operating items in the six months period ended June 30, 2012 and 2011 amounted to a net gain of RUB 12,823 million and loss of RUB 29,442 million, respectively. The change was primarily driven by appreciation of USD against RUB by 2% and depreciation of EURO against RUB by 1%, compared to depreciation of USD against RUB by 8% and relative stability of EURO in the same period of the prior year.

Other operating expenses

Other operating expenses increased by 31% to RUB 91,732 million in the six months period ended June 30, 2012 from RUB 70,142 million in the six months period ended June 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 changed from loss of RUB 2,838 million in the six months period ended June 30, 2011 to gain of RUB 20,388 million in the six months period ended June 30, 2012. The negative amount of changes in inventories of finished goods, work in progress and other effects in the six months period ended June 30, 2012 relates to the increase in the balances of finished goods as of June 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 236,362 million, or 28%, to RUB 612,133 million in the six months period ended June 30, 2012 from RUB 848,495 million in the same period of the prior year. Our operating profit margin decreased from 36% in the six months period ended June 30, 2011 to 27% in the six months period ended June 30, 2012.

Net finance (expense) income

(RUB million)	Six months ended June 30,	
	2012	2011
Exchange gains	139,894	99,110
Exchange losses	(164,224)	(25,307)
Net exchange (loss) gain	(24,330)	73,803
Interest income	13,492	7,557
Interest expense	(17,839)	(19,368)
Gains on extinguishment of restructured liabilities	7	98
Net finance (expense) income	(28,670)	62,090

Exchange gains increased by RUB 40,784 million to RUB 139,894 million in the six months period ended June 30, 2012 from RUB 99,110 million in the same period of the prior year. Exchange losses increased by RUB 138,917 million to RUB 164,224 million in the six months period ended June 30, 2012 from RUB 25,307 million in the same period of the prior year. The net exchange loss of RUB 24,330 million in the six months period ended June 30, 2012 in comparison with

net exchange gain of RUB 73,803 million in the same period of the prior year is explained by higher fluctuation of USD exchange rate against RUB in the six months period ended June 30, 2012 in comparison with the same period of the prior year.

Interest income increased by 79% to RUB 13,492 million in the six months period ended June 30, 2012 from RUB 7,557 million in the same period of the prior year, mainly due to increase of interest accrued on Group's cash and cash equivalents held with banks.

Interest expense decreased by 8% to RUB 17,839 million in the six months period ended June 30, 2012 from RUB 19,368 million in the same period of the prior year, mainly due to decrease in loans and borrowings, percentage from which relates to finance expenses.

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 9,123 million, or 15%, to RUB 71,689 million in the six months period ended June 30, 2012 compared to RUB 62,566 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 six months period ended June 30, 2012 relates mainly to the increase in net income of Sakhalin Energy Investment Company Ltd. due to the growth of liquefied natural gas sales; increase in net income of OAO Tomskneft VNK and its subsidiaries and OAO NGK Slavneft and its subsidiaries caused by the growth of oil prices. These effects were partly offset by the decrease in net income of Gazprombank Group in the six months period ended June 30, 2012 compared to the same period of the prior year.

Profit tax

Total profit tax expense decreased by RR 59,232 million, or 31%, to RR 129,548 million in the six months period ended June 30, 2012 compared to RR 188,780 million in the six months period ended June 30, 2011. The effective profit tax rate was 19.8% and 19.4% in the six months periods ended June 30, 2012 and 2011, respectively. Increase of the effective profit tax rate mainly resulted from a relative increase of non-deductable expenses in the six months period ended June 30, 2012 compared to the same period of the prior year.

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 263,002 million, or 34%, from RUB 771,669 million in the six months period ended June 30, 2011 to RUB 508,667 million in the six months period ended June 30, 2012.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 3,326 million, or 25%, to RUB 16,859 million in the six months period ended June 30, 2012 compared to RUB 13,533 million in the six months period ended June 30, 2011.

LIQUIDITY AND CAPITAL RESOURCES

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

(RUB million)	Six months ended June 30,	
	2012	2011
Net cash provided by operating activities	725,138	689,448
Net cash used for investing activities	(629,278)	(666,947)
Net cash (used for) provided by financing activities	(87,415)	1,776

Net cash provided by operating activities

Net cash provided by operating activities amounted to RUB 725,138 million in the six months period ended June 30, 2012 compared to RUB 689,448 million in the six months period ended June 30, 2011. The increase was primarily due to the positive dynamics of changes in working capital in the six months period ended June 30, 2012 in comparison with the same period of the prior year. This effect was partly offset by the decrease in profit before profit tax in the six months period ended June 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 37,669 million, or 6%, to RUB 629,278 million in the six months period ended June 30, 2012 compared to RUB 666,947 million in the six months period ended June 30, 2011. The decrease was primarily due to the increase in proceeds from associated undertakings and jointly controlled entities in the six months period ended June 30, 2012 in comparison with the same period of the prior year.

Net cash (used for) provided by financing activities

Net cash used for financing activities amounted to RUB 87,415 million in the six months period ended June 30, 2012 compared to net cash provided by financing activities in the amount of RUB 1,776 million in the six months period ended June 30, 2011. This change was mainly due to the decrease in proceeds from long-term borrowings in the six months period ended June 30, 2012 compared to the same period of the prior year.

Capital expenditures

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

(RUB million)	Six months periods ended June 30 ⁽¹⁾ ,	
	2012	2011
Transport	282,076	234,016
Production of gas	117,361	102,251
Refining	56,099	35,080
Production of crude oil and gas condensate	54,936	39,883
Distribution	20,516	13,904
Electric and heat energy generation and sales	19,115	23,365
Gas storage	3,619	4,833
All other segments	<u>6,195</u>	<u>15,606</u>
Total	559,917	468,938

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 90,979 million, or 19%, from RUB 468,938 million in the six months period ended June 30, 2011 to RUB 559,917 million in the six months period ended June 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-Torzhok and Nord Stream. 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 the 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) decreased by RUB 24,634 million, or 2%, from RUB 1,034,941 million as of December 31, 2011 to RUB 1,010,307 million as of June 30, 2012. This decrease resulted mainly from the redemption of long-term and short-term borrowings and increase in cash and cash equivalents.