

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

The following discussion and analysis should be read in conjunction with our unaudited consolidated interim condensed financial information as of and for the three months ended March 31, 2014. 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, 2013, 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 various goods, works, and 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 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 OPERATIONS

(RUB million)

	Three-month period ended March 31,	
	2014	2013
Sales	1,558,737	1,461,441
Net gain from trading activity	3,802	4,592
Operating expenses	<u>(1,089,749)</u>	<u>(950,052)</u>
Operating profit	472,790	515,981
Finance income	27,310	27,366
Finance expense	(203,087)	(51,292)
Share of net income (loss) of associated undertakings and joint ventures	20,907	(2,158)
Gains on disposal of available-for-sale financial assets	<u>30</u>	<u>22</u>
Profit before profit tax	317,950	489,919
Current profit tax expense	(62,599)	(6,705)
Deferred profit tax expense	<u>(23,687)</u>	<u>(95,062)</u>
Profit tax expense	(86,286)	(101,767)
Profit for the period	231,664	388,152
Other comprehensive income (loss):		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	(6,159)	753
Total items that will not be reclassified to profit or loss	(6,159)	753
Items that will be reclassified to profit or loss:		
Losses arising from change in fair value of available-for-sale financial assets, net of tax	(18,604)	(12,174)
Share of other comprehensive (loss) income of associated undertakings and joint ventures	(2,373)	1,178
Translation differences	73,684	7,439
(Losses) gains from cash flow hedges, net of tax	<u>(10,387)</u>	<u>1,037</u>
Total items that will be reclassified to profit or loss	42,320	(2,520)
Other comprehensive income (loss) for the period, net of tax	36,161	(1,767)
Total comprehensive income for the period	267,825	386,385
Profit attributable to:		
Owners of OAO Gazprom	223,007	380,665
Non-controlling interest	<u>8,657</u>	<u>7,487</u>
	231,664	388,152
Total comprehensive income attributable to:		
Owners of OAO Gazprom	255,860	378,647
Non-controlling interest	<u>11,965</u>	<u>7,738</u>
	267,825	386,385

Sales

The following table sets out our volumes and realized prices:

(RUB million unless indicated otherwise)	Three-month period ended March 31,	
	2014	2013
Sales of gas		
<i>Europe and Other Countries</i>		
Gross sales ⁽¹⁾	611,257	538,132
Customs duties	(126,878)	(109,818)
Net sales	484,379	428,314
Volumes in billion cubic meters (bcm)	46.7	45.4
Gross average price, U.S.\$ per mcm ⁽²⁾ (including customs duties) ⁽³⁾	372.4	390.0
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	13,087.3	11,862.8
<i>FSU (Former Soviet Union)</i>		
Gross sales ⁽¹⁾	138,021	146,605
Customs duties	(11,262)	(24,828)
Net sales	126,759	121,777
Volumes in bcm	16.3	18.2
Gross average price, U.S.\$ per mcm ⁽²⁾ (including customs duties) ⁽³⁾	241.3	265.2
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	8,479.0	8,066.0
<i>Russian Federation</i>		
Gross sales (net of VAT)	298,814	280,298
Net sales	298,814	280,298
Volumes in bcm	84.5	90.3
Gross average price, RUB per mcm ⁽²⁾ (net of VAT)	3,534.8	3,104.5
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,048,092	965,035
Customs duties	(138,140)	(134,646)
Retroactive gas price adjustments	-	73,430
Net sales	909,952	903,819
Volumes in bcm	147.5	153.9
Net sales of refined products (net of excise tax, VAT and customs duties)	380,658	319,178
Net sales of electric and heat energy (net of VAT)	134,614	106,851
Net sales of crude oil and gas condensate (net of VAT and customs duties)	49,339	52,280
Gas transportation net sales (net of VAT)	40,301	41,232
Other revenues (net of VAT)	43,873	38,081
Total sales (net of excise tax, VAT and customs duties)	1,558,737	1,461,441

Notes:

⁽¹⁾ VAT is not charged on sales to Europe and Other Countries as well as FSU 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 excise tax, VAT and customs duties) increased by RUB 97,296 million, or 7%, to RUB 1,558,737 million in the three-month period ended March 31, 2014 compared to the same period of the prior year.

Net sales of gas accounted for 58% and 62% of total net sales in the three-month period ended March 31, 2014 and 2013, respectively.

Net sales of gas increased by RUB 6,133 million, or 1%, from RUB 903,819 million in the three-month period ended March 31, 2013 to RUB 909,952 million in the three-month period ended March 31, 2014.

Net sales of gas to Europe and Other Countries increased by RUB 56,065 million, or 13%, to RUB 484,379 million in the three-month period ended March 31, 2014 as compared to the three-month period ended March 31, 2013. Overall increase in sales of gas to Europe and Other Countries was mainly driven by a 10% increase in gross

average Rouble price (including customs duties) as compared to the same period of the prior year. Volume of gas sold in the three-month period ended March 31, 2014 increased by 3% compared to the same period of the prior year.

Retroactive gas price adjustments were recognized in the unaudited consolidated interim condensed financial information for the three-month period ended March 31, 2013 as RUB 73,430 million increase in sales reflecting a decrease in a previously recognized accrual.

Net sales of gas to FSU countries increased by RUB 4,982 million, or 4%, to RUB 126,759 million in the three-month period ended March 31, 2014 compared to the same period of the prior year. The change was due to an increase of 5% in the gross average Rouble price (including customs duties) as compared to the three-month period ended March 31, 2013. Volumes of gas sold decreased by 10% in the three-month period ended March 31, 2014, compared to the same period of the prior year.

Net sales of gas in the Russian Federation increased by RUB 18,516 million, or 7%, to RUB 298,814 million in the three-month period ended March 31, 2014 compared to the same period of the prior year. The change was mainly due to a 14% increase in the gross average domestic gas prices. Volumes of gas sold decreased by 6% in the three-month period ended March 31, 2014 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 61,480 million, or 19%, to RUB 380,658 million in the three-month period ended March 31, 2014 in comparison with the same period of the prior year. The increase was primarily driven by an increase in volumes sold by organisations of Gazprom Neft Group to customers in the Russian Federation as well as by an increase in prices. In the three-month period ended March 31, 2014 and 2013 Gazprom Neft Group's sales comprised 69% and 73% of the total amount of net sales of refined products, respectively.

Net sales of electric and heat energy (net of VAT) increased by RUB 27,763 million, or 26%, to RUB 134,614 million in the three-month period ended March 31, 2014 compared to the same period of the prior year. The increase was mainly driven by inclusion of OAO Moscow Integrated Power Company (OAO MIPC) in the consolidated financial statements from September 2013.

Net sales of crude oil and gas condensate (net of VAT and customs duties) decreased by RUB 2,941 million, or 6%, to RUB 49,339 million in the three-month period ended March 31, 2014 compared to RUB 52,280 million in the same period of the prior year. Sales of crude oil included in net sales of crude oil and gas condensate (net of VAT and customs duties), amounted to RUB 42,730 million and RUB 42,815 million in the three-month period ended March 31, 2014 and 2013, respectively.

Operating expenses

Operating expenses increased by 15% in the three-month period ended March 31, 2014 to RUB 1,089,749 million from RUB 950,052 million in the same period of the prior year. Operating expenses as a percentage of sales increased from 65% in the three-month period ended March 31, 2013 to 70% in the three-month period ended March 31, 2014. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Three-month period ended March 31,	
	2014	2013
Taxes other than on income	205,713	182,816
Purchased gas and oil	180,471	187,280
Staff costs	129,000	119,854
Depreciation	114,748	109,873
Transit of gas, oil and refined products	95,517	86,453
Charge for impairment provisions	74,705	13,314
Cost of goods for resale, including refined products	61,201	30,750
Materials	60,186	52,084
Repairs and maintenance	25,847	31,445
Electricity and heating expenses	23,946	23,729
Transportation services	8,858	7,459
Rental expenses	8,427	5,874
Insurance expenses	6,312	5,385
Social expenses	5,983	8,890
Derivatives losses	4,973	6,444
Research and development expenses	4,734	4,714
Processing services	4,357	3,507
Heat transmission	43	3,835
Exchange rate differences on operating items	(45,088)	(5,318)
Other	76,729	43,695
	<u>1,046,662</u>	<u>922,083</u>
Changes in inventories of finished goods, work in progress and other effects	43,087	27,969
Total operating expenses	<u>1,089,749</u>	<u>950,052</u>

Taxes other than on income

Taxes other than income tax consist of:

(RUB million)	Three-month period ended March 31,	
	2014	2013
Natural resources production tax	154,127	131,701
Property tax	21,846	19,392
Other taxes	<u>29,740</u>	<u>31,723</u>
Taxes other than on income	205,713	182,816

The natural resources production tax increased by 17% to RUB 154,127 million in the three-month period ended March 31, 2014 as compared to RUB 131,701 million in the three-month period ended March 31, 2013. The increase is mainly due to an increase in the tax rate for natural gas from RUB 582 in the first quarter of 2013 to RUB 700 per thousand cubic meters since January 1, 2014. The increase in natural resources production tax on oil extraction resulted mainly from growth in the base tax rate from RUB 470 to RUB 493 per ton and increase of U.S. dollar exchange rate, included in calculation of oil production tax in accordance with the Tax Code of the Russian Federation.

Purchased gas and oil

Cost of purchased gas and oil decreased by RUB 6,809 million to RUB 180,741 million in the three-month period ended March 31, 2014 as compared to RUB 187,280 million in the same period of the prior year. Cost of purchased gas decreased by RUB 16,886 million, or 12%. This decrease mainly relates to decline in prices for the gas purchased from third parties in Russia and abroad.

Cost of purchased oil included in the cost of purchased gas and oil increased by RUB 10,077 million, or 20%, and amounted to RUB 60,184 million in the three-month period ended March 31, 2014 as compared with RUB 50,107 million in the same period of the prior year. The change is mainly related to activity of Gazprom Germany Group, included in scope of Gazprom Group's consolidation.

Staff costs

Staff costs increased by 8% to RUB 129,000 million for the three-month period ended March 31, 2014 from RUB 119,854 million in the same period of the prior year. The increase was mainly driven by average salary indexation and increase in average number of personnel.

Depreciation

Depreciation increased by 4%, or RUB 4,875 million, to RUB 114,748 million in the three-month period ended March 31, 2014 from RUB 109,873 million in the same period of the prior year. The increase is primarily due to the growth in the fixed assets base and inclusion of OAO MIPC into the scope of consolidation from September 2013.

Transit of gas, oil and refined products

Transit of gas, oil and refined products increased by 10% to RUB 95,517 million in the three-month period ended March 31, 2014 from RUB 86,453 million in the same period of the prior year. This increase was mainly driven by increase in transportation volumes through the Nord Stream pipeline.

Charge for impairment provisions

Charge for impairment provisions increased by RUB 61,391 million as compared to the same period of the prior year and includes RUB 71 298 million and RUB 13 149 million of bad debt provision for accounts receivable in the three-month period ended March 31, 2014 and 2013, respectively. The change was mainly driven by accrual of provision for doubtful trade accounts receivable of NAK Naftogaz Ukraine.

Cost of goods for resale, including refined products

Cost of goods for resale, including refined products, increased from RUB 30,750 million in the three-month period ended March 31, 2013 to RUB 61,201 million in the three-month period ended March 31, 2014. The increase is mainly explained by revised classification of Group's trading activities, as well as an increase in volumes of refined products purchased externally by Gazprom Neft Group.

Materials

Cost of materials increased by 16% to RUB 60,186 million in the three-month period ended March 31, 2014 from RUB 52,084 million in the same period of the prior year. The increase mainly relates to the inclusion of OAO MIPC in the consolidated financial statements from September 2013, as well as to an increase in purchases of materials from third parties.

Repairs and maintenance

Cost of repairs and maintenance decreased by 18% to RUB 25,847 million for the three-month period ended March 31, 2014 from RUB 31,445 million in the same period of the prior year. The decrease was mainly caused by a decline in the volume of repair services rendered by third parties to the Group during three-month period ended March 31, 2014.

Exchange rate differences on operating items

Exchange rate differences on operating items amounted to a net gain of RUB 45,088 million in the three-month period ended March 31, 2014 as compared with a net gain of RUB 5,318 million in the same period of the prior year. The change is explained by appreciation of U.S. dollar and Euro against Rouble by 9% in the three-month period ended March 31, 2014, compared to appreciation of U.S. dollar against Rouble by 2% and depreciation of Euro against Rouble by 1% in the same period of the prior year.

Other operating expenses

Other operating expenses increased by 76% to RUB 76,729 million in the three-month period ended March 31, 2014 from RUB 43,695 million in 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

Change in inventories of finished goods, work in progress and other effects increased by RUB 15,118 million to RUB 43,087 million in the three-month period ended March 31, 2014 as compared with RUB 27,969 million in the same period of the prior year. The positive amount of the line item in the three-month period ended March 31, 2014

is mainly due to a decrease in the balances of finished goods as of March 31, 2014 as compared with the balances as of December 31, 2013.

Operating profit

As a result of the factors discussed above, our operating profit decreased by RUB 43,191 million, or 8%, to RUB 472,790 million in the three-month period ended March 31, 2014 from RUB 515,981 million in the three-month period ended March 31, 2013. The operating profit margin decreased from 35% in the three-month period ended March 31, 2013 to 30% in the three-month period ended March 31, 2014.

Net finance loss

(RUB million)	Three-month period ended March 31,	
	2014	2013
Exchange gains	19,634	21,641
Exchange losses	<u>(191,610)</u>	<u>(44,281)</u>
Net exchange loss	(171,976)	(22,640)
Interest income	7,676	5,725
Interest expense	<u>(11,477)</u>	<u>(7,011)</u>
Net finance loss	(175,777)	(23,926)

The net exchange loss of RUB 171,976 million in the three-month period ended March 31, 2014 in comparison with net exchange loss of RUB 22,640 million in the same period of the prior year is mainly explained by appreciation of U.S. dollar and Euro against Rouble by 9% in the three-month period ended March 31, 2014, compared to appreciation of U.S. dollar against Rouble by 2% and depreciation of Euro against Rouble by 1% in the same period of the prior year. The exchange losses recognized were primarily related to non-operating items such as foreign denominated borrowings.

Interest income increased by RUB 1,951 million, or 34%, to RUB 7,676 million in the three-month period ended March 31, 2014 from RUB 5,725 million in the same period of the prior year.

Interest expense increased by 64% to RUB 11,477 million in the three-month period ended March 31, 2014 from RUB 7,011 million in the same period of the prior year, mainly due to increase in loans and borrowings, interest expense from which relates to finance expense in the three-month period ended March 31, 2014, as compared to the same period of the prior year.

Share of net income (loss) of associated undertakings and joint ventures

Share of net profit of associated undertakings and joint ventures amounted to RUB 20,907 million in the three-month period ended March 31, 2014 as compared to share of net loss in the amount of RUB 2,158 million the same period of the prior year. The change is mainly due to recognition of an additional expense of RUB 25,961 million for OAO NGK Slavneft and its subsidiaries as a result of a one-time adjustment to correct the prior understatement of depreciation on the basis difference for property, plant and equipment since the Group's acquisition of interests in OAO NGK Slavneft. Without this effect the measure decreased by RUB 2,896 million, mainly as a result of a decrease in profit from associated undertakings and joint ventures of Gazprom Germania Group, Gazprombank Group, which partially offset by increase in profit from Sakhalin Energy Investment Company Ltd and Nord Stream AG.

Profit tax

Total profit tax expense decreased by RUB 15,481 million, or 15%, to RUB 86,286 million in the three-month period ended March 31, 2014 as compared with RUB 101,767 million in the three-month period ended March 31, 2013. The effective profit tax rate was 27.1% and 20.8% in the three-month period ended March 31, 2014 and 2013, respectively.

The change in effective profit tax rate was mainly driven by an increase in non-deductible expenses for tax purposes, which were primarily related to accrual of provision for doubtful trade accounts receivable of NAK Naftogaz of Ukraine.

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 157,658 million, or 41%, from RUB 380,665 million in the three-month period ended March 31, 2013 to RUB 223,007 million in the three-month period ended March 31, 2014.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest increased by RUB 1,170 million, or 16%, to RUB 8,657 million in the three-month period ended March 31, 2014 compared to RUB 7,487 million in the same period of the prior year.

Liquidity and capital resources

The following table summarizes our statement of cash flows for the three-month period ended March 31, 2014 and 2013:

(RUB million)	Three-month period ended March 31,	
	2014	2013
Net cash from operating activities	688,422	517,873
Net cash used in investing activities	(411,286)	(398,770)
Net cash (used in) from financing activities	(22,148)	26,108

Net cash from operating activities

Net cash from operating activities increased by RUB 170,549 million, or 33%, and amounted to RUB 688,422 million in the three-month period ended March 31, 2014 as compared with RUB 517,873 million in the same period of the prior year. The increase was primarily due to positive dynamics in working capital changes.

Net cash used in investing activities

Net cash used in investing activities increased by RUB 12,516 million, or 3%, to RUB 411,286 million in the three-month period ended March 31, 2014 as compared with RUB 398,770 million in the same period of the prior year. The increase was primarily due to decrease in proceeds from loans issued in the three-month period ended March 31, 2014 as compared with the same period of the prior year.

Net cash (used in) from financing activities

Net cash used in financing activities amounted to RUB 22,148 million in the three-month period ended March 31, 2014 as compared with net cash from financing activities in the amount of RUB 26,108 million in the same period of the prior year. This change was primarily due to change from net proceeds of borrowings in the three-month period ended March 31, 2013 to net repayment of borrowings in the three-month period ended March 31, 2014.

Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the three-month period ended March 31, 2014 and 2013 in nominal RUB terms, amounted to the following:

(RUB million)	Three-month period ended March 31,	
	2014 ⁽¹⁾	2013 ⁽¹⁾
Transport	77,560	48,611
Production of natural gas	57,626	49,018
Production of crude oil and gas condensate	55,489	37,403
Refining	20,518	24,755
Electric and heat energy generation and sales	10,883	16,699
Distribution	3,720	4,281
Gas storage	1,964	4,001
All other segments	<u>8,226</u>	<u>14,369</u>
Total	235,986	199,137

Note:

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

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RUB 36,849 million, or 19%, from RUB 199,137 million in the three-month period ended March 31, 2013 to RUB 235,986 million in the three-month period ended March 31, 2014.

The increase in capital expenditures in the Transport segment was due to construction of Bovanenkovo-Ukhta pipeline system and extension of the unified gas supply system to ensure gas supply to South Stream pipeline. The increase in capital expenditures in Production of crude oil and gas condensate segment was mainly due to the increase of capital expenditures of Gazprom нефт 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 and 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 142,855 million, or 13%, from RUB 1,112,798 million as of December 31, 2013 to RUB 969,943 million as of March 31, 2014. This decrease resulted from the increase in cash and cash equivalents, which was partially offset by appreciation of U.S. dollar and Euro against Rouble.