

## **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 nine months ended September 30, 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 and production. 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 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; 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.

During nine-month period ended September 30, 2014 the Russian Rouble significantly depreciated against major currencies, by 20% against the U.S. dollar and 11% against the Euro, in particular. Even though the Rouble depreciated against the U.S. dollar or Euro it has a positive effect on our sales. However it also increases the rouble equivalent of our debt denominated in foreign currencies and the rouble equivalent of the cost of such debt adversely affected our results of operations.

World market prices for crude oil declined significantly in late 2014. As international crude oil prices decrease, the natural gas prices we realize under our long-term contracts with European or other customers that are linked to oil product indices may decline as well, resulting in a reduction in our export revenues. Ongoing and any further decline may adversely affect our business, results of operations, cash flows, financial condition and potentially our capital program.

## RESULTS OF OPERATIONS

(RUB million)

	<b>Nine-month period ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
Sales	4,007,522	3,772,668
Net gain from trading activity	9,903	7,073
Operating expenses	<u>(3,018,824)</u>	<u>(2,596,841)</u>
<b>Operating profit</b>	<b>998,601</b>	<b>1,182,900</b>
Finance income	189,629	88,019
Finance expense	(501,883)	(209,834)
Share of net income of associated undertakings and joint ventures	71,493	35,799
(Losses) gains on disposal of available-for-sale financial assets	<u>(981)</u>	<u>92</u>
<b>Profit before profit tax</b>	<b>756,859</b>	<b>1,096,976</b>
Current profit tax expense	(141,027)	(112,669)
Deferred profit tax expense	<u>(43,178)</u>	<u>(107,976)</u>
Profit tax expense	(184,205)	(220,645)
<b>Profit for the period</b>	<b>572,654</b>	<b>876,331</b>
Other comprehensive income:		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(66,523)</u>	61,490
<b>Total items that will not be reclassified to profit or loss</b>	<b>(66,523)</b>	<b>61,490</b>
Items that will be reclassified to profit or loss:		
(Losses) gains arising from change in fair value of available-for-sale financial assets, net of tax	(12,070)	9,027
Share of other comprehensive (loss) income of associated undertakings and joint ventures	(5,209)	7,785
Translation differences	142,779	47,630
Losses from cash flow hedges, net of tax	<u>(16,741)</u>	<u>(3,059)</u>
<b>Total items that will be reclassified to profit or loss</b>	<b>108,759</b>	<b>61,383</b>
<b>Other comprehensive income for the period, net of tax</b>	<b>42,236</b>	<b>122,873</b>
<b>Total comprehensive income for the period</b>	<b>614,890</b>	<b>999,204</b>
<b>Profit attributable to:</b>		
Owners of OAO Gazprom	556,254	858,773
Non-controlling interest	<u>16,400</u>	<u>17,558</u>
	<b>572,654</b>	<b>876,331</b>
<b>Total comprehensive income attributable to:</b>		
Owners of OAO Gazprom	595,918	978,691
Non-controlling interest	<u>18,972</u>	<u>20,513</u>
	<b>614,890</b>	<b>999,204</b>

## Sales

The following table sets out our volumes and realized prices:

(RUB million unless indicated otherwise)	<b>Nine-month period ended September 30,</b>	
	<b>2014</b>	<b>2013</b>
<b>Sales of gas</b>		
<i>Europe and Other Countries</i>		
Gross sales <sup>(1)</sup>	1,532,699	1,535,996
Customs duties	(305,609)	(311,681)
Net sales	1,227,090	1,224,315
Volumes in billion cubic meters (bcm)	122.5	126.8
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including customs duties) <sup>(3)</sup>	352.7	382.5
Gross average price, RUB per mcm <sup>(2)</sup> (including customs duties)	12,509.8	12,114.8
<i>FSU (Former Soviet Union)</i>		
Gross sales <sup>(1)</sup>	367,195	350,258
Customs duties	(62,243)	(60,543)
Net sales	304,952	289,715
Volumes in bcm	36.7	42.2
Gross average price, U.S.\$ per mcm <sup>(2)</sup> (including customs duties) <sup>(3)</sup>	281.9	262.1
Gross average price, RUB per mcm <sup>(2)</sup> (including customs duties)	10,000.7	8,301.7
<i>Russian Federation</i>		
Gross sales (net of VAT)	552,362	536,925
Net sales	552,362	536,925
Volumes in bcm	157.9	170.8
Gross average price, RUB per mcm <sup>(2)</sup> (net of VAT)	3,498.6	3,143.0
<i>Total sales of gas</i>		
Gross sales (net of VAT)	2,452,256	2,423,179
Customs duties	(367,852)	(372,224)
Retroactive gas price adjustments	-	73,430
Net sales	2,084,404	2,124,385
Volumes in bcm	317.1	339.8
Net sales of refined products (net of excise tax, VAT and customs duties)	1,226,510	1,002,091
Net sales of electric and heat energy (net of VAT)	291,941	250,972
Net sales of crude oil and gas condensate (net of VAT and customs duties)	152,394	155,429
Gas transportation net sales (net of VAT)	125,279	120,727
Other revenues (net of VAT)	<u>126,994</u>	<u>119,064</u>
<b>Total sales (net of excise tax, VAT and customs duties)</b>	<b><u>4,007,522</u></b>	<b><u>3,772,668</u></b>

Notes:

<sup>(1)</sup> VAT is not charged on sales to Europe and Other Countries as well as FSU countries.

<sup>(2)</sup> One mcm is equivalent to 35,316 cubic feet.

<sup>(3)</sup> 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 234,854 million, or 6%, to RUB 4,007,522 million in the nine-month period ended September 30, 2014 compared to the same period of the prior year.

Net sales of gas accounted for 52% and 56% of total net sales in the nine-month period ended September 30, 2014 and 2013, respectively.

Net sales of gas decreased by RUB 39,981 million, or by 2%, from RUB 2,124,385 million in the nine-month period ended September 30, 2013 to RUB 2,084,404 million in the nine-month period ended September 30, 2014.

Net sales of gas to Europe and Other Countries increased by RUB 2,775 million to RUB 1,227,090 million in the nine-month period ended September 30, 2014 as compared to the nine-month period ended September 30, 2013. Overall increase in net sales of gas to Europe and Other Countries was mainly driven by a 3% increase in the gross

average Rouble price (including customs duties) as compared to the same period of the prior year. Volumes of gas sold in the nine-month period ended September 30, 2014 decreased by 3% compared to the same period in 2013.

Net sales of gas to FSU countries increased by RUB 15,237 million, or 5%, to RUB 304,952 million in the nine-month period ended September 30, 2014 compared to the same period in 2013. The change was due to a 20% increase in the gross average Rouble price (including customs duties) as compared to the same period of the prior year. Volumes of gas sold decreased by 13% in the nine-month period ended September 30, 2014 compared to the same period of the prior year.

Net sales of gas in the Russian Federation increased by RUB 15,437 million, or 3%, to RUB 552,362 million in the nine-month period ended September 30, 2014 compared to the same period of the prior year due to an 11% increase in the gross average domestic gas prices. Volumes of gas sold decreased by 8% in the nine-month period ended September 30, 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 224,419 million, or 22%, to RUB 1,226,510 million in the nine-month period ended September 30, 2014 in comparison with the same period of the prior year. The increase was primarily driven by an increase in volumes sold by Gazprom Neft Group to customers in the Russian Federation, as well as by an increase in prices.

Net sales of electric and heat energy (net of VAT) increased by RUB 40,969 million, or 16%, to RUB 291,941 million in the nine-month period ended September 30, 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.

## Operating expenses

Operating expenses increased by 16% in the nine-month period ended September 30, 2014 to RUB 3,018,824 million from RUB 2,596,841 million in the same period of the prior year. Operating expenses as a percentage of sales increased from 69% in the nine-month period ended September 30, 2013 to 75% in the nine-month period ended September 30, 2014. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Nine-month period ended September 30,	
	2014	2013
Purchased gas and oil	573,784	558,311
Taxes other than on income	571,173	518,035
Staff costs	388,033	345,998
Depreciation	345,081	310,907
Transit of gas, oil and refined products	284,194	259,517
Cost of goods for resale, including refined products	209,641	102,408
Materials	198,679	169,244
Charge for impairment provisions	138,453	33,947
Repairs and maintenance	120,982	133,556
Electricity and heating expenses	62,044	57,497
Social expenses	29,524	30,790
Rental expenses	26,584	18,386
Transportation services	22,629	22,239
Insurance expenses	19,482	17,673
Research and development expenses	17,085	10,516
Processing services	13,257	11,734
Derivatives losses (gains)	11,487	(5,481)
Heat transmission	180	5,171
Foreign exchange rate differences on operating items	(101,913)	(37,792)
Other	180,866	151,560
	<b>3,111,245</b>	<b>2,714,216</b>
Changes in inventories of finished goods, work in progress and other effects	<u>(92,421)</u>	<u>(117,375)</u>
<b>Total operating expenses</b>	<b>3,018,824</b>	<b>2,596,841</b>

### *Purchased gas and oil*

Cost of purchased gas and oil increased by RUB 15,473 million, or 3%, to RUB 573,784 million in the nine-month period ended September 30, 2014 as compared to RUB 558,311 million in the same period of the prior year.

Cost of purchased oil included in the cost of purchased gas and oil increased by RUB 15,464 million, or 10%, and amounted to RUB 171,547 million in the nine-month period ended September 30, 2014 as compared to RUB 156,083 million in the same period of the prior year. The change is mainly related to activity of Gazprom neft Group and increase in average oil prices, denominated in roubles.

Cost of purchased gas changed insignificantly and amounted to RUB 402,237 million in the nine-month period ended September 30, 2014 as compared to RUB 402,228 million in the same period of the prior year.

### *Taxes other than on income*

Taxes other than on income consist of:

(RUB million)	Nine-month period ended 30 September,	
	2014	2013
Mineral extraction tax	411,774	369,293
Property tax	67,099	57,876
Other taxes	92,300	90,866
<b>Taxes other than on income</b>	<b>571,173</b>	<b>518,035</b>

The mineral extraction tax (MET) increased by 12% to RUB 411,774 million in the nine-month period ended September 30, 2014 as compared to RUB 369,293 million in the nine-month period ended September 30, 2013. The increase is mainly due to dynamics of mineral extraction tax rate for natural gas and oil.

#### *Staff costs*

Staff costs increased by 12% to RUB 388,033 million in the nine-month period ended September 30, 2014 from RUB 345,998 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 11%, or RUB 34,174 million, to RUB 345,081 million in the nine-month period ended September 30, 2014 from RUB 310,907 million in the same period of the prior year. The increase is primarily due to the growth in the fixed assets base.

#### *Transit of gas, oil and refined products*

Transit of gas, oil and refined products increased by 10% to RUB 284,194 million in the nine-month period ended September 30, 2014 from RUB 259,517 million in the same period of the prior year. This increase was mainly driven by growth of gas volumes transported through the Nord Stream pipeline.

#### *Cost of goods for resale, including refined products*

Cost of goods for resale, including refined products, increased from RUB 102,408 million in the nine-month period ended September 30, 2013 to RUB 209,641 million in the nine-month period ended September 30, 2014. The increase is mainly explained by an increase in volumes of refined products purchased from third parties.

#### *Materials*

Cost of materials increased by 17% to RUB 198,679 million in the nine-month period ended September 30, 2014 from RUB 169,244 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 and increase in prices.

#### *Charge for impairment provisions*

Charge for impairment provisions increased by RUB 104,506 million in the nine-month period ended September 30, 2014 as compared to the same period of the prior year. Such an increase was mainly driven by accrual of provision for doubtful trade accounts receivable of NAK Naftogaz Ukraine in the amount of RUB 83,927 million.

#### *Exchange rate differences on operating items*

Exchange rate differences on operating items amounted to a net gain of RUB 101,913 million in the nine-month period ended September 30, 2014 as compared with a net gain of RUB 37,792 million in the same period of the prior year. The change is explained by appreciation of U.S. dollar against Rouble by 20% and appreciation of Euro against Rouble by 11% in the nine-month period ended September 30, 2014, compared to appreciation of U.S. dollar against Rouble by 6% and appreciation of Euro against Rouble by 9% in the same period of the prior year. Significant foreign exchange rate differences for the nine-month period ended September 30, 2014 are primarily related to operating items such as accounts receivable and accounts payable.

#### *Other operating expenses*

Other operating expenses increased by 19% to RUB 180,866 million in the nine-month period ended September 30, 2014 from RUB 151,560 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 decreased by RUB 24,954 million to RUB 92,421 million in the nine-month period ended September 30, 2014 as compared to RUB 117,375 million in the same period of the prior year. The negative amount of the line item in the nine-month period ended September 30, 2014 is mainly due to an increase in the balances of finished goods as of September 30, 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 184,299 million, or 16%, to RUB 998,601 million in the nine-month period ended September 30, 2014 from RUB 1,182,900 million in the nine-month period ended September 30, 2013. The operating profit margin decreased from 31% in the nine-month period ended September 30, 2013 to 25% in the nine-month period ended September 30, 2014.

## Net finance loss

(RUB million)	Nine-month period ended September 30,	
	2014	2013
Exchange gains	150,083	62,252
Exchange losses	<u>(470,797)</u>	<u>(177,652)</u>
Net exchange loss	(320,714)	(115,400)
Interest income	39,546	25,767
Interest expense	<u>(31,086)</u>	<u>(32,182)</u>
<b>Net finance loss</b>	<b>(312,254)</b>	<b>(121,815)</b>

The net exchange loss of RUB 320,714 million in the nine-month period ended September 30, 2014 in comparison with net exchange loss of RUB 115,400 million in the same period of the prior year is explained by appreciation of U.S.dollar and Euro against Rouble by 20% and 11%, respectively, in the nine-month period ended September 30, 2014, compared to appreciation of U.S.dollar and Euro by 6% and 9%, respectively, in the same period of the prior year.

Interest income increased by 53% to RUB 39,546 million in the nine-month period ended September 30, 2014 from RUB 25,767 million in the same period of the prior year.

Interest expense decreased by 3% to RUB 31,086 million in the nine-month period ended September 30, 2014 from RUB 32,182 million in the same period of the prior year.

## Share of net income of associated undertakings and joint ventures

Share of net income of associated undertakings and joint ventures increased by RUB 35,694 million to RUB 71,493 million in the nine-month period ended September 30, 2014 as compared to RUB 35,799 million in the same period of the prior year. The change is mainly due to recognition of an additional expense of RUB 25,961 million in the nine-month period ended September 30, 2013 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 increased by RUB 9,733 million, which was mainly caused by an increase in net income of Sakhalin Energy Investment Company Ltd. due to an increase in sales of liquefied natural gas and crude oil as a result of an increase in average Rouble prices, an increase in net income of Nord Stream AG due to an increase in gas transportation sales, which was partially offset by a decrease in profit of Gazprombank Group.

## Profit tax

Total profit tax expense decreased by RUB 36,440 million, or 17%, to RUB 184,205 million in the nine-month period ended September 30, 2014 as compared to RUB 220,645 million in the nine-month period ended September 30, 2013. The effective profit tax rate was 24.3% and 20.1% in the nine-month period ended September 30, 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 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 302,519 million, or 35%, from RUB 858,773 million in the nine-month period ended September 30, 2013 to RUB 556,254 million in the nine-month period ended September 30, 2014.

### **Profit for the period attributable to non-controlling interest**

Profit for the period attributable to non-controlling interest decreased by RUB 1,158 million, or 7%, to RUB 16,400 million in the nine-month period ended September 30, 2014 compared to RUB 17,558 million in the same period of the prior year.

### **Liquidity and capital resources**

The following table summarizes our statement of cash flows for the nine-month period ended September 30, 2014 and 2013:

(RUB million)	Nine-month period ended September 30,	
	2014	2013
Net cash from operating activities	1,300,155	1,291,798
Net cash used in investing activities	(1,017,911)	(1,095,868)
Net cash used in financing activities	(241,852)	(72,590)

#### *Net cash from operating activities*

Net cash from operating activities increased by RUB 8,357 million, or 1%, and amounted to RUB 1,300,155 million in the nine-month period ended September 30, 2014 as compared to RUB 1,291,798 million in the same period of the prior year. The increase was primarily due to positive dynamics in working capital changes. This effect was offset by increase in profit tax paid in the nine-month period ended September 30, 2014 in comparison with the same period of the prior year.

#### *Net cash used in investing activities*

Net cash used in investing activities decreased by RUB 77,957 million, or 7%, to RUB 1,017,911 million in the nine-month period ended September 30, 2014 as compared to RUB 1,095,868 million in the same period of the prior year. The change was primarily due to a decrease in cash used for capital expenditures in the nine-month period ended September 30, 2014 as compared to the same period of the prior year.

#### *Net cash used in financing activities*

Net cash used in financing activities amounted to RUB 241,852 million in the nine-month period ended September 30, 2014 as compared to RUB 72,590 million in the same period of the prior year. This change was primarily due to a decrease in proceeds from long-term borrowings and increase in dividends paid in the nine-month period ended September 30, 2014 as 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 nine-month period ended September 30, 2014 and 2013 in nominal RUB terms, amounted to the following:

(RUB million)	Nine-month period ended September 30,	
	2014 <sup>(1)</sup>	2013 <sup>(1)</sup>
Transport	327,111	253,454
Production of crude oil and gas condensate	179,505	192,702
Production of gas	179,199	209,370
Refining	84,299	90,470
Electric and heat energy generation and sales	56,896	58,998
Distribution	16,030	23,417
Gas storage	7,510	17,147
All other segments	<u>28,377</u>	<u>54,770</u>
<b>Total</b>	<b>878,927</b>	<b>900,328</b>

Note:

<sup>(1)</sup> 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) decreased by RUB 21,401 million, or 2%, from RUB 900,328 million in the nine-month period ended September 30, 2013 to RUB 878,927 million in the nine-month period ended September 30, 2014.

The increase in capital expenditures in Transport segment was due to construction of Bovanenkovo-Ukhta gas pipeline system and extension of the unified gas supply system to ensure gas supply to South Stream pipeline.

In December 2014 a decision was taken to cease the South Stream project. On 29 December 2014 the Group became the owner of 100% of the interest in South Stream Transport B.V., the company responsible for the offshore part of the project, by acquiring shares of EDF International S.A.S., Wintershall Holding GmbH and ENI International B.V. The Group is currently assessing the impact of the decision and acquisition of the additional share in South Stream Transport B.V. on its annual consolidated financial statements.

The decrease in capital expenditures in Production of gas segment was primarily due to launch of Kirinskoye field.

## 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) increased by RUB 152,329 million, or 14%, from RUB 1,112,798 million as of December 31, 2013 to RUB 1,265,127 million as of September 30, 2014. This increase resulted from depreciation of Rouble against U.S. dollar and Euro that was partially offset by increase in cash and cash equivalents.