

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

*The following discussion and analysis of financial condition and results of operations should be read in conjunction with the unaudited consolidated interim condensed financial information for the six months ended June 30, 2015. This consolidated interim condensed financial information is prepared in accordance with International Accounting Standard 34 Interim Financial Reporting. The consolidated interim condensed financial information should be read in conjunction with the consolidated financial statements for the year ended December 31, 2014 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, 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.

## RESULTS OF OPERATION

(RUB million)	Six months ended June 30,	
	2015	2014
Sales	2,913,452	2,873,932
Net (loss) gain from trading activity	(7,953)	14,377
Operating expenses	<u>(2,224,215)</u>	<u>(2,248,659)</u>
<b>Operating profit</b>	<b>681,284</b>	<b>639,650</b>
Finance income	1,063,303	165,596
Finance expense	(949,422)	(218,540)
Share of net income of associated undertakings and joint ventures	61,415	47,884
Gains (losses) on disposal of available-for-sale financial assets	<u>430</u>	<u>(26)</u>
<b>Profit before profit tax</b>	<b>857,010</b>	<b>634,564</b>
Current profit tax expense	(122,538)	(124,525)
Deferred profit tax expense	<u>(43,216)</u>	<u>(44,813)</u>
Profit tax expense	(165,754)	(169,338)
<b>Profit for the period</b>	<b>691,256</b>	<b>465,226</b>
<b>Other comprehensive income (loss):</b>		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(118,428)</u>	<u>(6,463)</u>
<b>Total items that will not be reclassified to profit or loss</b>	<b>(118,428)</b>	<b>(6,463)</b>
Items that may be reclassified subsequently to profit or loss:		
Gains (losses) arising from change in fair value of available-for-sale financial assets, net of tax	38,783	(8,850)
Share of other comprehensive income (loss) of associated undertakings and joint ventures	11,619	(3,403)
Translation differences	(68,945)	13,667
Gains (losses) from cash flow hedges, net of tax	<u>13,478</u>	<u>(6,971)</u>
<b>Total items that may be reclassified subsequently to profit or loss</b>	<b>(5,065)</b>	<b>(5,557)</b>
<b>Other comprehensive loss for the period, net of tax</b>	<b>(123,493)</b>	<b>(12,020)</b>
<b>Total comprehensive income for the period</b>	<b>567,763</b>	<b>453,206</b>
<b>Profit attributable to:</b>		
Owners of PJSC Gazprom	675,904	450,578
Non-controlling interest	<u>15,352</u>	<u>14,648</u>
	<b>691,256</b>	<b>465,226</b>
<b>Total comprehensive income attributable to:</b>		
Owners of PJSC Gazprom	557,002	438,470
Non-controlling interest	<u>10,761</u>	<u>14,736</u>
	<b>567,763</b>	<b>453,206</b>

## Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Six months ended June 30,	
	2015	2014
<b>Sales of gas</b>		
<i>Europe and Other countries</i>		
Gross sales <sup>(1)</sup>	1,249,813	1,104,040
Customs duties	(258,262)	(220,844)
Excise tax	(44,931)	-
Net sales	946,620	883,196
Volumes in bcm	80.4	86.0
Gross average price, US Dollar per mcm <sup>(2)</sup> (including excise tax and customs duties) <sup>(3)</sup>	269.5	366.1
Gross average price, RUB per mcm <sup>(2)</sup> (including excise tax and customs duties)	15,551.5	12,843.4
<i>Former Soviet Union countries</i>		
Gross sales <sup>(1)</sup>	254,698	320,337
Customs duties	(25,060)	(57,390)
Net sales	229,638	262,947
Volumes in bcm	20.9	30.7
Gross average price, US Dollar per mcm <sup>(2)</sup> (including customs duties) <sup>(3)</sup>	211.0	297.7
Gross average price, RUB per mcm <sup>(2)</sup> (including customs duties)	12,176.6	10,445.7
<i>Russian Federation</i>		
Gross sales (net of VAT)	425,284	440,528
Net sales	425,284	440,528
Volumes in bcm	120.0	125.4
Gross average price, RUB per mcm <sup>(2)</sup> (net of VAT)	3,543.0	3,513.5
<i>Total sales of gas</i>		
Gross sales (net of VAT)	1,929,795	1,864,905
Customs duties	(283,322)	(278,234)
Excise tax	(44,931)	-
Retroactive gas price adjustments	17,220	-
Net sales	1,618,762	1,586,671
Volumes in bcm	221.3	242.1
Net sales of refined products (net of VAT, excise tax and customs duties)	761,603	793,632
Net electric and heat energy sales (net of VAT)	217,728	218,683
Net sales of crude oil and gas condensate (net of VAT and customs duties)	130,652	104,798
Net gas transportation sales (net of VAT)	90,621	82,721
Other revenues (net of VAT)	94,086	87,427
<b>Total sales (net of VAT, excise tax and customs duties)</b>	<b>2,913,452</b>	<b>2,873,932</b>

Notes:

<sup>(1)</sup> VAT is not charged on sales to Europe and Other countries as well as Former Soviet Union 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 US Dollar.

Total sales (net of VAT, excise tax and customs duties) increased by RUB 39,520 million, or 1 %, to RUB 2,913,452 million for the six months ended June 30, 2015 compared to the same period of the prior year. The increase in sales is mainly driven by the increase in gas sales to Europe and Other countries.

Net sales of gas accounted for 56 % and 55 % of total net sales for the six months ended June 30, 2015 and 2014, respectively.

Net sales of gas increased by RUB 32,091 million, or 2 %, from RUB 1,586,671 million for the six months ended June 30, 2014 to RUB 1,618,762 million for the six months ended June 30, 2015.

For the six months ended June 30, 2015 net sales of gas to Europe and Other countries increased by RUB 63,424 million, or 7 %, to RUB 946,620 million compared to the same period of the prior year. The overall increase in sales of gas to Europe and Other countries was mainly driven by the increase in gross average Russian Ruble price (including excise tax and customs duties) by 21 % compared to the same period of the prior year. Volume of gas sold for the six months ended June 30, 2015 decreased by 7 % compared to the same period of the prior year. At the same time gross average US Dollar price decreased by 26 %.

Net sales of gas to Former Soviet Union countries decreased by RUB 33,309 million, or 13 %, to RUB 229,638 million for the six months ended June 30, 2015 compared to the same period of the prior year. The change was due to 32 % decrease in volume of gas sold and 29 % decrease in the gross average US Dollar price for the six months ended June 30, 2015 compared to the same period of the prior year. At the same time gross average Russian Ruble price (including customs duties) increased by 17 % for the six months ended June 30, 2015 compared to the same period of the prior year.

Net sales of gas in the Russian Federation decreased by RUB 15,244 million, or 3 %, to RUB 425,284 million for the six months ended June 30, 2015 compared to the same period of the prior year. This is primarily explained by the decrease in volumes of gas sold by 4 % for the six months ended June 30, 2015 compared to the same period of the prior year.

### Operating expenses

Operating expenses decreased by 1 % for the six months ended June 30, 2015 to RUB 2,224,215 million from RUB 2,248,659 million for the same period of the prior year. Operating expenses as a percentage of sales decreased from 78 % for the six months ended June 30, 2014 to 76 % for the six months ended June 30, 2015. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Six months ended	
	June 30,	
	2015	2014
Taxes other than on income	429,063	394,392
Purchased gas and oil	391,851	382,928
Staff costs	289,681	259,288
Depreciation	250,635	228,784
Transit of gas, oil and refined products	242,826	191,409
Materials	128,941	133,393
Cost of goods for resale, including refined products	92,273	123,311
Repairs and maintenance	54,595	72,208
Foreign exchange rate differences on operating items	50,178	(3,566)
Electricity and heating expenses	45,295	44,461
Charge for impairment provisions	29,573	219,449
Rental expenses	20,449	17,580
Transportation services	20,205	16,034
Social expenses	13,367	16,215
Research and development expenses	13,335	8,558
Insurance expenses	12,475	12,410
Processing services	9,073	8,717
Derivatives (gains) losses	(16,046)	9,454
Other	171,201	132,443
	<b>2,248,970</b>	<b>2,267,468</b>
Changes in inventories of finished goods, work in progress and other effects	(24,755)	(18,809)
<b>Total operating expenses</b>	<b>2,224,215</b>	<b>2,248,659</b>

### *Taxes other than on income*

Taxes other than on income consist of:

(RUB million)	Six months ended June 30,	
	2015	2014
Mineral extraction tax	320,047	290,423
Property tax	60,022	45,408
Other taxes	48,994	58,561
<b>Taxes other than on income</b>	<b>429,063</b>	<b>394,392</b>

Mineral extraction tax increased by 10 % to RUB 320,047 million for the six months ended June 30, 2015 compared to RUB 290,423 million for the same period of the prior year. The increase is mainly due to dynamics of mineral extraction tax rate for natural gas and oil and increase in production of crude oil by Gazprom Neft Group.

### *Purchased gas and oil*

Cost of purchased gas and oil increased by RUB 8,923 million to RUB 391,851 million for the six months ended June 30, 2015 compared to RUB 382,928 million for the same period of the prior year. Cost of purchased gas increased by RUB 21,543 million, or 8 %. The change is mainly related to an increase in cost of gas purchased from third parties abroad.

Cost of purchased oil included in the purchased gas and oil decreased by RUB 12,620 million, or 10 %, to RUB 107,718 million for the six months ended June 30, 2015 compared to RUB 120,338 million for the same period of the prior year. The change is mainly related to decrease in cost of purchased oil.

### *Staff costs*

Staff costs increased by 12 % to RUB 289,681 million for the six months ended June 30, 2015 compared to RUB 259,288 million for 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 10 %, or RUB 21,851 million, to RUB 250,635 million for the six months ended June 30, 2015 compared to RUB 228,784 million for 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 27 % to RUB 242,826 million for the six months ended June 30, 2015 compared to RUB 191,409 million for the same period of the prior year. This increase was mainly driven by increase in cost of transit of gas through the Nord Stream pipeline and through the territory of Germany and Eastern Europe denominated in Ruble terms.

### *Materials*

Cost of materials decreased by 3 % to RUB 128,941 million for the six months ended June 30, 2015 compared to RUB 133,393 million for the same period of the prior year. The decrease mainly relates to decrease in purchases of materials from third parties.

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

Cost of goods for resale, including refined products, decreased from RUB 123,311 million for the six months ended June 30, 2014 to RUB 92,273 million for the six months ended June 30, 2015. The decrease is mainly explained by the decrease in volumes of refined products purchased from third parties.

### *Exchange rate differences on operating items*

Exchange rate differences on operating items for the six months ended June 30, 2015 amounted to a net loss of RUB 50,178 million compared to a net gain of RUB 3,566 million for the same period of the prior year. The change is explained by the depreciation of US Dollar against the Russian Ruble by 1 % and the depreciation of Euro against the Russian Ruble by 10 % for the six months ended June 30, 2015 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 3 % and 2 % respectively for the same period of the prior year.

### *Charge for impairment provisions*

Charge for impairment provisions decreased by RUB 189,876 million for the six months ended June 30, 2015 compared to the same period of the prior year. The decrease was mainly driven by charge for impairment provision for doubtful trade accounts receivable of NJSC Naftogaz Ukraine for the six months ended June 30, 2014.

### *Other operating expenses*

Other operating expenses increased by 29 % to RUB 171,201 million for the six months ended June 30, 2015 compared to RUB 132,443 million for 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 5,946 million to RUB 24,755 million for the six months ended June 30, 2015 compared to RUB 18,809 million for the same period of the prior year. The change in this line item is mainly due to a decrease in the balances of finished goods as of June 30, 2015 compared to the balances as of December 31, 2014.

### **Operating profit**

As a result of the factors discussed above, operating profit increased by RUB 41,634 million, or 7 %, to RUB 681,284 million for the six months ended June 30, 2015 from RUB 639,650 million for the same period of the prior year. The operating profit margin increased from 22 % for the six months ended June 30, 2014 to 23 % for the six months ended June 30, 2015.

### **Net finance gain (loss)**

(RUB million)	Six months ended June 30,	
	2015	2014
Exchange gains	1,007,461	149,754
Exchange losses	<u>(922,390)</u>	<u>(197,741)</u>
Net exchange gain (loss)	85,071	(47,987)
Interest income	55,842	15,842
Interest expense	<u>(27,032)</u>	<u>(20,799)</u>
<b>Net finance gain (loss)</b>	<b>113,881</b>	<b>(52,944)</b>

The net exchange gain of RUB 85,071 million for the six months ended June 30, 2015 compared to net exchange loss of RUB 47,987 million for the same period of the prior year is mainly explained by the depreciation of US Dollar against the Russian Ruble by 1 % and the depreciation of Euro against the Russian Ruble by 10 % for the six months ended June 30, 2015 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 3 % and 2 % respectively for the same period of the prior year.

Interest income increased by 252 % to RUB 55,842 million for the six months ended June 30, 2015 from RUB 15,842 million for the same period of the prior year. The change is mainly driven by an increase in accrued interest on bank balances of the Group.

Interest expense increased by 30 % to RUB 27,032 million for the six months ended June 30, 2015 compared to RUB 20,799 million for 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 13,531 million to RUB 61,415 million for the six months ended June 30, 2015 compared to RUB 47,884 million for the same period of the prior year. The change is mainly caused by an increase in net income of LLC Yamal razvitie and its subsidiaries by RUB 8,772 million and of Gazprom Germania Group by RUB 6,142 million due to increase in profit of these companies.

### **Profit tax**

Total profit tax expense decreased by RUB 3,584 million, or 2 %, to RUB 165,754 million for the six months ended June 30, 2015 compared to RUB 169,338 million for the same period of the prior year. The effective profit tax rate was 19.3 % and 26.7 % for the six months ended June 30, 2015 and June 30, 2014 respectively.

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

### **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 increased by RUB 225,326 million, or 50 %, from RUB 450,578 million for the six months ended June 30, 2014 to RUB 675,904 million for the six months ended June 30, 2015.

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

Profit for the period attributable to non-controlling interest increased by RUB 704 million, or 5 %, to RUB 15,352 million for the six months ended June 30, 2015 compared to RUB 14,648 million for the same period of the prior year.

### Liquidity and capital resources

The following table summarises the cash flows for the six months ended June 30, 2015 and 2014:

(RUB million)	Six months ended June 30,	
	2015	2014
Net cash from operating activities	985,237	986,143
Net cash used in investing activities	(839,373)	(698,150)
Net cash used in financing activities	(53,458)	(27,390)

#### *Net cash from operating activities*

Net cash from operating activities decreased by RUB 906 million, to RUB 985,237 million for the six months ended June 30, 2015 compared to RUB 986,143 million for the same period of the prior year.

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

Net cash used in investing activities increased by RUB 141,223 million, or 20 %, to RUB 839,373 million for the six months ended June 30, 2015 compared to RUB 698,150 million for the same period of the prior year. The change was primarily due to an increase in cash used for capital expenditures for the six months ended June 30, 2015 compared to the same period of the prior year.

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

Net cash used in financing activities increased by RUB 26,068 million, or 95 %, to RUB 53,458 million for the six months ended June 30, 2015 compared to RUB 27,390 million for the same period of the prior year. This change was primarily due to excess of cash used for repayment of borrowings over proceeds from borrowings for the six months ended June 30, 2015.

### Capital expenditures

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) by segment for the six months ended June 30, 2015 and 2014 in nominal RUB terms, amounted to the following:

(RUB million)	Six months ended June 30,	
	2015 <sup>(1)</sup>	2014 <sup>(1)</sup>
Transport	245,686	176,389
Production of crude oil and gas condensate	142,164	110,510
Production of gas	65,961	112,897
Refining	57,092	45,143
Electric and heat energy generation and sales	30,549	30,023
Distribution	4,976	8,500
Gas storage	8,414	2,926
All other segments	25,456	14,584
<b>Total</b>	<b>580,298</b>	<b>500,972</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 PJSC Gazprom primarily due to VAT.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RUB 79,326 million, or 16 %, from RUB 500,972 million for the six months ended June 30, 2014 to RUB 580,298 million for the six months ended June 30, 2015.

### **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 201,042 million, or 12 %, from RUB 1,650,633 million as of December 31, 2014 to RUB 1,449,591 million as of June 30, 2015. This decrease resulted from decrease in long-term borrowings, change in foreign currency exchange rates (primarily, depreciation of Euro against the Russian Ruble) and increase in cash and cash equivalents.