

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 nine months ended September 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)	Nine months ended September 30,	
	2015	2014
Sales	4,206,217	4,007,522
Net gain from trading activity	8,320	9,903
Operating expenses	<u>(3,171,784)</u>	<u>(3,018,824)</u>
Operating profit	1,042,753	998,601
Finance income	1,145,005	189,629
Finance expense	(1,421,168)	(501,883)
Share of net income of associated undertakings and joint ventures	93,181	71,493
Gains (losses) on disposal of available-for-sale financial assets	<u>5,066</u>	<u>(981)</u>
Profit before profit tax	864,837	756,859
Current profit tax expense	(130,177)	(141,027)
Deferred profit tax expense	<u>(44,389)</u>	<u>(43,178)</u>
Profit tax expense	(174,566)	(184,205)
Profit for the period	690,271	572,654
Other comprehensive income (loss):		
Items that will not be reclassified to profit or loss:		
Remeasurements of post-employment benefit obligations	<u>(84,204)</u>	<u>(66,523)</u>
Total items that will not be reclassified to profit or loss	(84,204)	(66,523)
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	47,294	(12,070)
Share of other comprehensive income (loss) of associated undertakings and joint ventures	26,133	(5,209)
Translation differences	164,804	142,779
Losses from cash flow hedges, net of tax	<u>(4,777)</u>	<u>(16,741)</u>
Total items that may be reclassified subsequently to profit or loss	233,454	108,759
Other comprehensive income for the period, net of tax	149,250	42,236
Total comprehensive income for the period	839,521	614,890
Profit attributable to:		
Owners of PJSC Gazprom	673,904	556,254
Non-controlling interest	<u>16,367</u>	<u>16,400</u>
	690,271	572,654
Total comprehensive income attributable to:		
Owners of PJSC Gazprom	815,437	595,918
Non-controlling interest	<u>24,084</u>	<u>18,972</u>
	839,521	614,890

Sales

The following table sets out volumes and realized prices:

(RUB million unless indicated otherwise)	Nine months ended September 30,	
	2015	2014
Sales of gas		
<i>Europe and Other countries</i>		
Gross sales ⁽¹⁾	1,883,132	1,532,699
Customs duties	(390,265)	(305,609)
Excise tax	(62,395)	-
Net sales	1,430,472	1,227,090
Volumes in bcm	125.3	122.5
Gross average price, US Dollar per mcm ⁽²⁾ (including excise tax and customs duties) ⁽³⁾	252.1	352.7
Gross average price, RUB per mcm ⁽²⁾ (including excise tax and customs duties)	15,033.7	12,509.8
<i>Former Soviet Union countries</i>		
Gross sales ⁽¹⁾	323,496	367,195
Customs duties	(31,494)	(62,243)
Net sales	292,002	304,952
Volumes in bcm	27.2	36.7
Gross average price, US Dollar per mcm ⁽²⁾ (including customs duties) ⁽³⁾	199.2	281.9
Gross average price, RUB per mcm ⁽²⁾ (including customs duties)	11,875.3	10,000.7
<i>Russian Federation</i>		
Gross sales (net of VAT)	538,572	552,362
Net sales	538,572	552,362
Volumes in bcm	150.6	157.9
Gross average price, RUB per mcm ⁽²⁾ (net of VAT)	3,576.7	3,498.6
<i>Total sales of gas</i>		
Gross sales (net of VAT)	2,745,200	2,452,256
Customs duties	(421,759)	(367,852)
Excise tax	(62,395)	-
Retroactive gas price adjustments	12,074	-
Net sales	2,273,120	2,084,404
Volumes in bcm	303.1	317.1
Net sales of refined products (net of VAT, excise tax and customs duties)	1,175,078	1,226,510
Net electric and heat energy sales (net of VAT)	291,603	291,941
Net sales of crude oil and gas condensate (net of VAT and customs duties)	184,636	152,394
Net gas transportation sales (net of VAT)	139,068	125,279
Other revenues (net of VAT)	<u>142,712</u>	<u>126,994</u>
Total sales (net of VAT, excise tax and customs duties)	<u>4,206,217</u>	<u>4,007,522</u>

Notes:

⁽¹⁾ VAT is not charged on sales to Europe and Other countries as well as Former Soviet Union countries.

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

⁽³⁾ Calculated on the basis of average exchange rate between RUB and US Dollar.

Total sales (net of VAT, excise tax and customs duties) increased by RUB 198,695 million, or 5 %, to RUB 4,206,217 million for the nine months ended September 30, 2015 compared to the same period of the prior year. The increase in sales is mainly driven by the increase in sales of gas to Europe and Other countries.

Net sales of gas accounted for 54 % and 52 % of total net sales for the nine months ended September 30, 2015 and 2014, respectively.

Net sales of gas increased by RUB 188,716 million, or 9 %, from RUB 2,084,404 million for the nine months ended September 30, 2014 to RUB 2,273,120 million for the nine months ended September 30, 2015.

For the nine months ended September 30, 2015 net sales of gas to Europe and Other countries increased by RUB 203,382 million, or 17 %, to RUB 1,430,472 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 20 % compared to the same period of the prior year. Volumes of gas sold for the nine months ended September 30, 2015 increased by 2 % compared to the same period of the prior year. At the same time gross average US Dollar price decreased by 29 %.

Net sales of gas to Former Soviet Union countries decreased by RUB 12,950 million, or 4 %, to RUB 292,002 million for the nine months ended September 30, 2015 compared to the same period of the prior year. The change was due to the 26 % decrease in volumes of gas sold and the 29 % decrease in the gross average US Dollar price for the nine months ended September 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 19 % for the nine months ended September 30, 2015 compared to the same period of the prior year.

Net sales of gas in the Russian Federation decreased by RUB 13,790 million, or 2 %, to RUB 538,572 million for the nine months ended September 30, 2015 compared to the same period of the prior year. This is primarily explained by the decrease in volumes of gas sold by 5 % for the nine months ended September 30, 2015 compared to the same period of the prior year.

Operating expenses

Operating expenses increased by 5 % for the nine months ended September 30, 2015 to RUB 3,171,784 million from RUB 3,018,824 million for the same period of the prior year. Operating expenses as a percentage of sales for the nine months ended September 30, 2015 is equal to the figure for the same period of the prior year, 75 %. The table below presents a breakdown of operating expenses in each period:

(RUB million)	Nine months ended	
	September 30,	
	2015	2014
Taxes other than on income	611,932	571,173
Purchased gas and oil	605,902	573,784
Staff costs	433,120	388,033
Transit of gas, oil and refined products	381,481	284,194
Depreciation	380,041	345,081
Materials	201,581	198,679
Cost of goods for resale, including refined products	145,772	209,641
Repairs and maintenance	106,109	120,982
Electricity and heating expenses	64,752	62,044
Charge for impairment provisions	51,964	138,453
Transportation services	30,891	22,629
Rental expenses	26,934	26,584
Research and development expenses	22,553	17,085
Social expenses	21,713	29,524
Insurance expenses	20,093	19,482
Processing services	14,004	13,257
Derivatives (gains) losses	(21,625)	11,487
Foreign exchange rate differences on operating items	(47,668)	(101,913)
Other	229,111	181,046
	3,278,660	3,111,245
Changes in inventories of finished goods, work in progress and other effects	(106,876)	(92,421)
Total operating expenses	3,171,784	3,018,824

Taxes other than on income

Taxes other than on income consist of:

(RUB million)	Nine months ended September 30,	
	2015	2014
Mineral extraction tax	447,174	411,774
Property tax	88,355	67,099
Other taxes	<u>76,403</u>	<u>92,300</u>
Taxes other than on income	611,932	571,173

Mineral extraction tax increased by 9 % to RUB 447,174 million for the nine months ended September 30, 2015 compared to RUB 411,774 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 an increase in production of crude oil by Gazprom Neft Group.

Purchased gas and oil

Cost of purchased gas and oil increased by RUB 32,118 million to RUB 605,902 million for the nine months ended September 30, 2015 compared to RUB 573,784 million for the same period of the prior year. Cost of purchased gas increased by RUB 35,559 million, or 9 %. 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 3,441 million, or 2 %, to RUB 168,106 million for the nine months ended September 30, 2015 compared to RUB 171,547 million for the same period of the prior year. The change is mainly related to a decrease in oil prices.

Staff costs

Staff costs increased by 12 % to RUB 433,120 million for the nine months ended September 30, 2015 compared to RUB 388,033 million for the same period of the prior year. The increase was mainly driven by average salary indexation and an increase in average number of personnel.

Depreciation

Depreciation increased by 10 %, or RUB 34,960 million, to RUB 380,041 million for the nine months ended September 30, 2015 compared to RUB 345,081 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 34 % to RUB 381,481 million for the nine months ended September 30, 2015 compared to RUB 284,194 million for the same period of the prior year. This increase was mainly driven by an increase in cost of transit of gas through the Nord Stream pipeline and through the territory of Ukraine, Germany and Eastern Europe denominated in Ruble terms.

Materials

Cost of materials increased by 1 % to RUB 201,581 million for the nine months ended September 30, 2015 compared to RUB 198,679 million for the same period of the prior year. The increase mainly relates to an increase 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 209,641 million for the nine months ended September 30, 2014 to RUB 145,772 million for the nine months ended September 30, 2015. The decrease is mainly explained by the decrease in volumes of refined products purchased from third parties.

Foreign exchange rate differences on operating items

Exchange rate differences on operating items for the nine months ended September 30, 2015 amounted to a net gain of RUB 47,668 million compared to a net gain of RUB 101,913 million for the same period of the prior year. The change is explained by the appreciation of US Dollar against the Russian Ruble by 18 % and the appreciation of Euro against the Russian Ruble by 9 % for the nine months ended September 30, 2015 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 20 % and 11 % respectively for the same period of the prior year.

Charge for impairment provisions

Charge for impairment provisions decreased by RUB 86,489 million for the nine months ended September 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 nine months ended September 30, 2014.

Other operating expenses

Other operating expenses increased by 27 % to RUB 229,111 million for the nine months ended September 30, 2015 compared to RUB 181,046 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

Changes in inventories of finished goods, work in progress and other effects increased by RUB 14,455 million to RUB 106,876 million for the nine months ended September 30, 2015 compared to RUB 92,421 million for the same period of the prior year. The change in this line item is mainly due to an increase in the balances of finished goods as of September 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 44,152 million, or 4 %, to RUB 1,042,753 million for the nine months ended September 30, 2015 from RUB 998,601 million for the same period of the prior year. The operating profit margin for the nine months ended September 30, 2015 is equal to the figure for the same period of the prior year, 25 %.

Net finance loss

(RUB million)	Nine months ended September 30,	
	2015	2014
Exchange gains	1,063,545	150,083
Exchange losses	<u>(1,378,852)</u>	<u>(470,797)</u>
Net exchange loss	(315,307)	(320,714)
Interest income	81,460	39,546
Interest expense	<u>(42,316)</u>	<u>(31,086)</u>
Net finance loss	<u>(276,163)</u>	<u>(312,254)</u>

The decrease of the net exchange loss by RUB 5,407 million, or 2 %, for the nine months ended September 30, 2015 compared to RUB 320,714 million for the same period of the prior year is mainly explained by the appreciation of US Dollar against the Russian Ruble by 18 % and the appreciation of Euro against the Russian Ruble by 9 % for the nine months ended September 30, 2015 compared to the appreciation of US Dollar and Euro against the Russian Ruble by 20 % and 11 % respectively for the same period of the prior year.

Interest income increased by 106 % to RUB 81,460 million for the nine months ended September 30, 2015 from RUB 39,546 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 36 % to RUB 42,316 million for the nine months ended September 30, 2015 compared to RUB 31,086 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 21,688 million to RUB 93,181 million for the nine months ended September 30, 2015 compared to RUB 71,493 million for the same period of the prior year. The change is mainly caused by an increase in share of net income of LLC Yamal razvitie and its subsidiaries by RUB 14,134 million and of KazRosGaz LLP by RUB 3,891 million due to an increase in profit of these companies and by an increase in share of net income of Sakhalin Energy Investment Company Ltd. by RUB 4,381 million due to the appreciation of US Dollar against the Russian Ruble.

Profit tax

Total profit tax expense decreased by RUB 9,639 million, or 5 %, to RUB 174,566 million for the nine months ended September 30, 2015 compared to RUB 184,205 million for the same period of the prior year. The effective profit tax rate was 20.2 % and 24.3 % for the nine months ended September 30, 2015 and September 30, 2014 respectively.

The change in effective profit tax rate was mainly driven by a 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 117,650 million, or 21 %, from RUB 556,254 million for the nine months ended September 30, 2014 to RUB 673,904 million for the nine months ended September 30, 2015.

Profit for the period attributable to non-controlling interest

Profit for the period attributable to non-controlling interest decreased by RUB 33 million to RUB 16,367 million for the nine months ended September 30, 2015 compared to RUB 16,400 million for the same period of the prior year.

Liquidity and capital resources

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

(RUB million)	Nine months ended September 30,	
	2015	2014
Net cash from operating activities	1,395,331	1,300,155
Net cash used in investing activities	(1,206,358)	(1,017,911)
Net cash used in financing activities	(153,389)	(241,852)

Net cash from operating activities

Net cash from operating activities increased by RUB 95,176 million, to RUB 1,395,331 million for the nine months ended September 30, 2015 compared to RUB 1,300,155 million for the same period of the prior year. This change is mainly driven by positive dynamics of working capital and a decrease in income tax paid.

Net cash used in investing activities

Net cash used in investing activities increased by RUB 188,447 million, or 19 %, to RUB 1,206,358 million for the nine months ended September 30, 2015 compared to RUB 1,017,911 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 nine months ended September 30, 2015 compared to the same period of the prior year.

Net cash used in financing activities

Net cash used in financing activities decreased by RUB 88,463 million, or 37 %, to RUB 153,389 million for the nine months ended September 30, 2015 compared to RUB 241,852 million for the same period of the prior year. This change was primarily due to excess of proceeds from borrowings over cash used for repayment of borrowings for the nine months ended September 30, 2015.

Capital expenditures

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

(RUB million)	Nine months ended September 30,	
	2015 ⁽¹⁾	2014 ⁽¹⁾
Transport	377,316	327,111
Production of crude oil and gas condensate	219,640	179,505
Production of gas	154,756	179,199
Refining	125,115	84,299
Electric and heat energy generation and sales	54,477	56,896
Distribution	11,927	16,030
Gas storage	20,135	7,510
All other segments	45,625	28,377
Total	1,008,991	878,927

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 PJSC Gazprom primarily due to VAT.

Total capital expenditures (excluding the effect of acquisitions of subsidiaries) increased by RUB 130,064 million, or 15 %, from RUB 878,927 million for the nine months ended September 30, 2014 to RUB 1,008,991 million for the nine months ended September 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) increased by RUB 372,086 million, or 23 %, from RUB 1,650,633 million as of December 31, 2014 to RUB 2,022,719 million as of September 30, 2015. This increase resulted from an increase in long-term and short-term borrowings and change in foreign currency exchange rates.