

Information about Major Business Risks and Uncertainties of PJSC LUKOIL

The Management of PJSC LUKOIL pays great attention to the risk management issues in order to ensure reasonable achievement of the set goals in the conditions characterized by uncertainties and adverse factors. LUKOIL constantly identifies, describes, estimates and monitors the potential events that may affect the Company's activities, and elaborates measures to prevent them or mitigate their negative impact to the greatest extent possible if such events do take place.

The Company seeks to actively promote risk management and is presently focusing its efforts on the improvement of an enterprise-wide risk management system (ERM) based on the best international practices. The Company is constantly improving the applicable regulatory methodological risk management base which establishes requirements, uniform for all of the LUKOIL Group entities, aimed at organizing the risk management process at all stages, and defines management standards for certain risk types of utmost importance. In 2011, a special board under the LUKOIL President, the Risks Committee, began functioning in the company.

Displayed at the company's official site is information on Risk Management and Internal Control Policy of PJSC LUKOIL, which establishes uniform basic principles and approaches, binding within LUKOIL, of a system of risk management and internal control, the system's main objectives and also the principal tasks of the system's participants.

In order to enhance the efficiency of the corporate-wide governance system through the establishment of a unified information environment, there is an automated risk management system, and it is being perfected.

The following information reflects the Company's current vision of the major risks that may affect its financial performance, and may be not exhaustive.

Macroeconomic Risks

Macroeconomic changes resulting from the global price volatility for energy carriers, foreign exchange rate fluctuations, inflation processes may have an adverse impact on the Company's financial performance.

As distinct from the beginning of the year, Q2 of 2017 saw growing price volatility at the oil market against the backdrop of growing production in Nigeria, Lybia, and the continuing recovery of oil production in the U.S. The global resources did not show any signs of significant reduction either. In this connexion, the extension on the present terms in late May of 2017 of the agreement to cut oil production for another 9 months caused the disappointment of market players as they doubt that the measures taken are sufficient. As a result, in the end of June, the oil prices hit the year's floor.

Speaking of major macroeconomic and political risks, special mention should go to growing trade restrictions all over the world, higher political uncertainty, greater disproportion in regional development and the growth of debt load. In mid-June, the Federal Reserve System raised the interest rate and announced plans to cut its balance. Besides, it has been registered that the sentiment of the world's major central banks is changing towards a tighter fiscal policy. In view of the risk of slower investment rate and higher debt load, greater borrowing costs may result in a global economic slowdown and higher demand for oil.

Against the backdrop of strict abidance by the agreement to cut oil production and the seasonal pickup in motor fuel consumption in Q3 of 2017, the demand for oil is expected to rise significantly and the feedstocks to fall. However, analysts believe that higher oil production by independent producers, and also in Nigeria and Lybia, presents a threat of the rebalancing of the market and may again cause a surplus in 2018. The realization of this scenario would add even more significance to further steps by OPEC+ to rebalance the oil market.

Nevertheless, we can expect an oil price growth in the mid-term perspective due to the delayed effect of the reduced investment by the oil and gas companies. The growing oil demand will be subject to continued motorization and industry expansion in the developing countries.

Russian economy still counters the global challenges connected with low prices for energy carriers and the continued sectoral sanctions According to the Russian Statistics Committee, the GDP grew in Q1 of 2017 by 0.5% on a year-to-year basis. Despite some recovery, the internal development factors of Russian economy remain limited. The stronger exchange rate of the ruble considerably impairs the ability of Russian-made goods to compete, whereas the home demand is insufficient due to the restrictive effect of the structural factors. In mid-June, the Central Bank of Russia reduced the interest rate to 9%, yet even this figure is too high for investment activity to resume. The imposition of the sanctions has impeded access to foreign financing and technologies for Russian companies. Positive growth rates for Russian economy in 2017 are contingent on a sustained oil price of more than 50 dollars per barrel.

The Company has been employing a scenario approach to forecast macroeconomic indicators. One of them is defined as a base-case scenario and describes the most likely macroeconomic development trends according to the Company's management. In addition, best-case and worst-case scenarios are being developed. They assess the potential consequences of changes in macroeconomic indices for the Company.

The Company is fully committed to minimizing the potential negative effects resulting from the realization of macroeconomic risks. The application of the worst-case scenario makes it possible to identify assets and investment projects that are most vulnerable to macroeconomic changes. The data of this analysis serve as the basis for top management decisions to optimize the Company's asset portfolio.

Country Risks

Among other things, LUKOIL has operations in a number of countries with high political and economic risks. Should they be realized, such risks may significantly complicate the Company's business or even cause the Company to suspend its operations in a certain region. In particular, the Company has launched a number of projects in Iraq, Egypt, Uzbekistan and West African countries where country risks are deemed high.

The Company seeks to diversify its operations and alongside with its activities in unstable regions has been managing projects in Europe and the US, where regional risks are considered minimal.

The major part of the Company's production and refining assets is located in the Russian Federation. The political environment in the RF is characterized by a fair degree of stability and of people's trust in the policies undertaken by the President and the Government.

The main factors which are capable of affecting PJSC LUKOIL's activities include:

- Instability of the political situation in the countries where the Company is implementing its investment projects, due to regime changes;
- Escalation of military conflicts in the countries of the Company's presence;
- Macroeconomic instability in the countries of the Company's presence;
- Expropriation of the Company's assets;
- Inefficiency of the legislation regulating economic relations, and of the court system.

When implementing projects with high country risks, the Company applies more stringent return level requirements to such projects. Besides, should the political or social and economic situation deteriorate in a region of the Company's presence, LUKOIL shall implement a set of crisis response measures, including cost saving, optimization of the investment program based on the new conditions, equity drawdown, and the bringing in of partners to share project risks.

Industry-Specific Risks

Risks Associated with Well Construction and Hard-to-recover Hydrocarbon Field Development

The risk associated with the prohibition of supply of the equipment and materials currently used for well construction is essential to the Company. The fact that a considerable share of the materials and equipment required for well construction is purchased today by the Company and its contractors from foreign contractors is regarded as a risk factor.

The greatest part of the chemical agents intended for preparation and processing of drill muds, as well as for preparation of grouting mixtures currently purchased from the EU and the US manufacturers, can be replaced with the products manufactured by the enterprises of China, Thailand, the RF and the Republic of Belarus. It is also worth mentioning that the chemical products currently purchased from the EU and the US manufacturers are low-tonnage.

Based on the information received from the Company's contractors providing maintenance services during well construction, as of today, the Company's projects have now stocked spare parts, equipment and supplies for one year.

Due to the sanctions imposed against Russia there is a risk of constraints arising as hard-to-recover-hydrocarbon fields are developed with application of the multi-zone hydrofracturing technique. The equipment for multi-zone hydrofracturing used today as part of the Company's projects knows no equals produced by the enterprises of the RF or China.

Risks Associated with the Growth of Tariffs and Suppliers' Prices for Goods/Work/Services in Operations, except Critical Raw Material

The risk associated with tariff growth is accounted for by the activities of such monopolies as JSC RZhd, PJSC Gazprom and other monopolies in the countries of the Company's presence, since the prices for their services grow on a regular basis.

The expenses on product logistics, as the product volumes rise, directly affect LUKOIL profit.

There is also a risk of price growth for the services of other suppliers, including motor transportation, the services of customs brokers, warehouse storage cost, etc.

In order to minimize the risks associated with the tariff growth of JSC RZhd, and other similar monopolies in the countries of its presence, the Company:

- diversifies ways to transport the Company's products;
- in order to reduce the risks of advanced tariff growth of the above monopolies the Company participates, together with other consumers, in the coordinated operations aimed at the prevention of advanced tariff growth;
- when suppliers are selected to cooperate on a long-term basis, the Company holds bidding procedures.

Risk of Restricted Access to Petroleum Product Transshipment Infrastructure

The risk scenario depends on:

- inability to ensure safety of goods in transit on the part of the natural monopolist in petroleum product pipeline transport;
- limited infrastructure capabilities given the growth in third-party transportation, and changes in the quality of transported goods.
- the political situation.

The Company invests great efforts to find ways to reduce these risks:

- diversifies types of transport and petroleum product export destinations;
- conducts systematic work with natural monopolies in terms of pipeline transfer to increase transportation output through the PJSC Transneft system given the ever-growing oil production rates and/or increasing refining output at the Company's refineries;
- develops its own transportation and logistics infrastructure to satisfy oil and petroleum product export.

Financial Risks

Price Risks

Oil and petroleum product price fluctuations may significantly affect the issuer's financial performance and the value of its securities. The issuer has a limited influence on the output prices which depend a lot on the market situation and measures taken by the regulatory authorities.

High oil price volatility is expected to persist in the near term as a result of the uncertainty as to the outlooks of the global economic growth, interruptions of oil supply to the market, the gap between the global oil demand and supply, and high geopolitical tensions.

The issuer is a vertically integrated oil company which embraces production, refining and distribution assets. This structure serves as a natural hedging mechanism, where multidirectional risk factors compensate one other.

In addition to this, the Company uses a number of measures to reduce the negative price risk impact:

- As long-term programs are developed, several price scenarios are considered, while the investment project portfolio is formed in view of the tolerance analysis of the project performance figures to the changes in price parameters;
- A commodity supply management system has been implemented which makes it possible to respond to market changes very fast and conduct arbitral shipments;
- In its trading activities, the Company uses hedging operations which help significantly reduce the negative impact of the price fluctuations on oil and oil product markets as part of the Group operations.

Liquidity Risks

High volatility of oil prices, exchange rates of foreign currencies to the US dollar, refining margin, petrochemistry and power generation margin, sales margin, growth of tariffs and suppliers' prices, as well as possible international economic sanctions in connection with the RF foreign policy (including in Ukraine) may create an imbalance in the figures included into the plans, budgets and investment programs of LUKOIL Group, thus leading to the shortage of liquidity and financing sources.

This risk is managed through sensitivity assessment of the performance figures included into the plans, budgets and investment programs to the changes in macroeconomic indicators. The Company also develops proposals related to plan adjustments, possible sequestering of expenses associated with the transition to the stress scenario, shifting of due dates and project implementation dates or inclusion of optional projects in the plan in case of improvements in the

macroeconomic situation, as well as the proposals to ensure well-timed financing of its business activities. Much attention is paid to cost minimization by means of bidding procedures.

LUKOIL Group's liquidity is managed on a centralized basis, but there's also an efficient global system in place to manage it, which includes an automated system of concentration and re-distribution of funds, corporate dealing, and cashflow rolling forecasts. The liquidity indicators are monitored on a continuous basis.

Despite the unfavorable market situation for the Russian borrowers, the volume of bilateral backup credit lines required to provide a sufficient level of liquidity in line with the requirements of the rating agencies is maintained at the required level.

Currently, LUKOIL has investment ratings from two largest international rating agencies, including: S&P (BBB-, which is higher than the sovereign rating of the Russian Federation) and Fitch (BBB-). The Company is monitoring and ensuring compliance of its financial indicators with the rating agencies' requirements on a regular basis.

The fact that its credit rating exceeds the sovereign rating of the Russian Federation testifies to high financial stability of LUKOIL.

Foreign Exchange Risks

The fact that the Company's assets are mainly concentrated in the RF makes its financial indicators dependent on the ruble to dollar exchange rate. The Company's proceeds are mainly shaped by US dollar proceeds from the oil and petroleum product sales, while operating and capital expenses are denominated in rubles. The Company has to sell foreign currency to finance ruble denominated expenses. When the ruble appreciates, the Company needs to sell an extra amount of its foreign currency proceeds to finance ruble denominated expenses, which will have an adverse effect on the Company's net profit in rubles.

The Company's currency revenue and expenses mix serves as natural hedging. For instance, an oil price reduction, as a rule, is accompanied by a weaker ruble exchange rate, which helps partially offset the negative impact of the oil price reduction on the Company's financial indicators.

In order to mitigate the negative consequences of the changes in the currency exchange rates the Company takes advantage of its geographic diversification. The Company also applies hedging tools to its currency proceeds.

Risk of Contractor's Default, Failure to Pay on the part of the Contractor

The risk manifests itself in the possibility of untimely proceeds from the supplied goods. As related to export sales, untimely and/or incomplete proceeds may require additional funds to ensure fulfillment of the Company's financial obligations.

This risk is minimized by the contractual terms in view of which the settlements with third parties, non-members of LUKOIL Group are either made on a pre-paid basis or secured by letters of credit or bank guarantees on the part of end buyers. The list of banks issuing letters of credit and bank guarantees is subject to approval by the Company's corporate center.

Legal Risks

Tax and Customs Regulation Risks

The actions of the RF government focused on amending the taxation and customs policy are primarily dictated by the state of the RF budget system and the way the domestic market is regulated. Increased tax burden, unexpected changes in the tax and customs duty rates, cancellation of the applicable incentive rates for a number of the Company's fields may affect financial performance of LUKOIL Group and its entities.

Due to considerable fluctuations of the ruble to dollar exchange rate in the recent months and a persisting trend towards further depreciation of the Russian ruble, there is a risk of additional payments of customs duties accompanied by occasional declaration of oil and petroleum product export supplies to exceed the planned amounts (except for pipeline transport supplies).

At the same time, in accordance with the Russian Law "On Customs Tariff" the Government of the Russian Federation reconsiders export customs duties on oil and petroleum products on a monthly basis. Customs duties are calculated based on what the oil price on the global oil markets is, therefore, as the oil price falls, the duty rates are reducing as well, however starting from the next calendar month.

Strong ruble rate volatility continues to bear significant risks and uncertainty in terms of the amount of the export duties paid in rubles.

To manage the specified risks the Company conducts continuous monitoring of the taxation and customs policy changes, participates in the discussions of legislative initiatives, promptly assesses the influence produced by the

probable changes in the taxation and customs legislation upon the LUKOIL Group performance indicators, and takes respective measures in order to either mitigate or offset the negative consequences of the changes in the taxation policy and customs policy, for example, if possible, to be able to submit customs declarations as the ruble to US dollar exchange rate is on the rise.

Risks Associated with Changes of the Russian Legislation on Joint-Stock Companies and Securities Markets

Changes in the Russian corporate governance regulations, including those related to the structure and competences of the regulatory bodies of a joint-stock company, as well as transition to practical application of the provisions of the Corporate Governance Code (Letter of the Bank of Russia No.06-52/2463 of April 10, 2014) in view of the reporting recommendations in accordance with the Corporate Governance Code (Letter of the Bank of Russia No.IN-06-52/8 of February 17, 2016) may lead to changes in the Company's corporate structure and corporate governance procedures, which in its turn may affect the Company's decision-making process and performance.

The Company is constantly monitoring legislation changes in this field. The Company also takes measures to collect information on such changes at the stage of preliminary discussion, and to ensure participation of the Company's representatives in such discussions in order to provide a detailed explanation of the Company's standpoint on these issues, risks and uncertainties which may arise as a result of the proposed legislative initiatives.

The Company also takes measures to ensure participation of its representatives in the activities focused on the development of efficient solutions in the area of practical application of the effective legislative innovations.

Risks Associated with Circulation of the Company's Securities

The Company's securities circulate in regulated markets in Russia and abroad. Changes in the requirements to the issuers on the part of the regulatory authorities for securities and stock exchanges, as well as the changes in the listing structure may induce the Company to amend its corporate governance procedures and assume extra obligations as to information disclosure and shareholder relations. Should the Company fail to ensure compliance with these requirements and fulfill the required obligations, it may result in transfer of the Company's securities to lower listing segments, including delisting, which may have an adverse impact on the liquidity and cost of the securities.

The Company monitors changes in the listing rules of stock exchanges and other requirements of stock exchanges and regulatory authorities to the issuers whose securities are admitted to trading. The Company's representatives participate in the working meetings and other issuer events arranged by stock exchanges and other organizations that provide consulting and educational services to the issuers of the securities traded on regulated markets. The Company also seeks to introduce the best global practice in corporate governance and shareholder relations.

Geological Risks

The Risk of Failure to Discover Geological Reserves or Discovery of the Reserves below the Initially Expected Level

The Company's business is exposed to the risk that while implementing new projects, and exploratory drilling, we might not discover any productive (commercially efficient) oil and gas reserves, and/or that the discovered reserves will be considerably below the initially expected level. In this event, the Company may have to incur additional expenses or even cease operations in a number of license areas.

LUKOIL performs activities to manage this risk at the level sufficient for prompt risk response, by means of additional geologic exploration, processing of seismic data and better methods of field 3D seismic studies.

Risks Associated with Subsurface Use and Licensing

The applicable Russian legislation on subsurface use and licensing of exploration and production activities, as well as their practical application expose oil companies to a number of risks. The most important are the following ones:

- risk of early termination of the subsoil license;
- risk of failure to provide the companies with equal access to the subsoil resources of the Continental Shelf;
- risk of having no legislative guarantees to grant the right to subsurface use to a legal entity that discovered a field of federal significance or a field located in the subsurface area of federal significance (Russian continental shelf, internal and territorial seas of the RF, as well as the Russian sector of the Caspian sea bottom), including the subsurface users with the share of foreign investors in the companies' authorized capital);
- risk of refusal to accept bidding documents for participation in competitive tenders/auctions in view of technicalities from subsurface users of the LUKOIL Group entities;
- risk of fines imposed for administrative offenses for failure to fulfill the terms of license agreements;

The Company is fully committed to minimizing the potential effects resulting from the realization of the above risks, including the following:

- conducts monitoring of the changes in the legislation and in the area of subsurface use and licensing, forwarding proposals to update the applicable regulatory framework;
- creates a list of sites associated with the Unallocated Subsoil Stock, which are of interest to the Company, in the oil and gas production companies, to ensure timely decision-making on participation of the LUKOIL Group entities in the tender/auction procedures for subsoil use rights. Prepares feasibility studies of new geological areas in the context of the existing basic USC;
- has established permanent working groups in the LUKOIL Group entities to develop the bidding documents to participate in the tenders/auctions and re-register licenses.
- holds annual advanced training workshops for specialists in the area of licensing and subsoil use, participates in workshops with government officers;
- monitors current subsoil use state with application of a special information system;
- interacts with the regulatory authorities in order to mitigate the risk of early subsoil license termination.

Risk of Terrorist Attacks, Wrongful Acts by Third Parties

As the number of terrorist organizations increases, as well as that of terrorist attacks in the countries of the Company's presence, there is a possibility of terrorist attacks and other wrongful acts against the Company's assets.

Additional risks for the Company's assets are caused by the progress in the military and political issues in the Middle East against the backdrop of the ongoing conflict in Syria and Iraq, the upcoming parliamentary elections in Iraq (September of 2017) and also the possible referendum on Iraqi Kurdistan's independence (September of 2017).

There are also risks related to wrongdoings on the part of LUKOIL's competitors (specifically, risks of unfair competition), risks of financial and other abuses on the part of LUKOIL Group employees, as well as those related to theft of financial resources and commodity stocks.

The Company manages this risk in the following key areas:

- participates in anti-terror events organized by the National Anti-terrorism Committee of Russia, the RF Federal Security Service, the RF Ministry of Internal Affairs;
- identifies persons who are intentionally inflicting harm on the Company's interests for the benefit of competitors and other third-party (including criminal) structures and persons;
- plans and arranges events aimed at information security improvement;
- implements the Information Safety Program in the LUKOIL Group Entities;
- obtains licenses issued by the RF Federal Security Services to use encryption-based information security tools.

HSE Risks

The Company is exposed to the risk of failure of technical equipment at hazardous production facilities, which may result in accidents, shutdowns, harmful emissions, negative environmental impact, fire and occupational injuries, including those occurring as a result of offshore oil and gas field development. This risk may result in unscheduled shutdowns of the production capacities and, consequently, failure to receive the expected level of operating income.

In order to mitigate these risks the Company has created and is successfully implementing its industrial safety system, including:

- the use of corporate standards, including without limitation those governing environmental safety matters;
- production control over the operation of hazardous production facilities;
- dedicated expert training;
- diagnostics (non-destructive inspection) and monitoring of equipment parameters;
- assessment of workplaces based on working conditions;
- repairs and timely replacement of equipment;
- building up a reserve for continuous preparedness of emergency response teams and resources;
- other measures to minimize accident rates at the Company's production facilities.

The applicable HSE Management System certified for compliance with the requirements of ISO 14001 and OHSAS 18001 international standards ensures prompt detection of discrepancies in work organization and equipment operation, as well as development and implementation of corporate target programs and plans in the sphere of industrial and fire safety, and also the training of service personnel and accident prevention services for response to emergencies.

Risks of Failure to Implement the Investment Program

While implementing investment projects, the Company has to face the risk of higher costs and untimely commissioning of production assets.

Delays in project implementation, including those caused by delays in preparing design and estimate documentation, in obtainment of approvals, in conclusion of contracts and in performance time, as well as changes in field development plans in connection with the collection of additional geological information, may result in a failure to implement the investment program. This may lead to inferior performance indicators for the subsequent years, lower efficiency of investment projects and the need to raise “excessive” funds.

The Company pays great attention to managing this risk by means of quarterly monitoring of project implementation progress as well as by investment program adjustment. As the investment program is developed, the greenfield development projects without any design and estimate documentation are excluded from the plans for the coming year.

Risk Associated with the Lack of Qualified Personnel

The competence and expertise of the newly recruited employees may prove insufficient for them to adequately fulfill their duties, which, in its turn, may adversely affect the financial performance indicators of the Company.

To mitigate the negative impact of this risk, the Company focuses on integrated development of the personnel potential. The Company keeps replenishing a specially created personnel pool consisting of the most experienced and promising employees; special attention is paid to the recruitment of young specialists and graduates.

Responsibility statement

I hereby confirm that to the best of my knowledge:

(a) the set of financial statements, which has been prepared in accordance with the International Financial Reporting Standards, gives a true and fair view of the assets, liabilities, financial position and profit or loss of the undertakings included in the consolidation as a whole as required by the Disclosure Guidance and Transparency Rules ('DTR') 4.2.4R,

(b) the interim management report includes a fair review of the information required by DTR 4.2.7R, being an indication of the important events that have occurred during the first six months of the financial year and their impact on the set of financial statements, and a description of the principal risks and uncertainties for the remaining six months of the financial year,

(c) the interim management report includes a fair review of the information required by DTR 4.2.8R, being related parties transactions that have taken place in the first six months of the current financial year and that have materially affected the financial position and performance of the enterprise during that period, and any changes in the related parties transactions described in the last annual report that could do so.

G. S. Fedotov,
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